# ESTATE PLANNING

# FOR

# THE B.C. FARMER

FIRST EDITION

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A study prepared for the B.C. Ministry of Agriculture and Food, Economics Branch, by Derek J. Fryer, Chartered Accountant, a partner in McKnight, Johnson and Partners.

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## PREFACE

The term "estate planning" is generally used to describe an orderly three stage process relating to the accumulation, management and eventual disposition or orderly transfer of assets from one generation to the next.

While income tax considerations are of great importance and are dealt with in some detail in this bulletin, the intention is to put tax matters into context with regard to each of these three stages. Each family member has a stake in the outcome of the plan and the interest or needs of each will change with the passage of time and changing circumstances.

The purpose of this publication is to provide a framework, present concepts and constitute a source of reference useful to farm families in designing an estate plan and in dealing with professionals who will assist in the development and documentation of the plan. Given today's high asset value of farm business in B.C. the need to design and implement a sound estate plan is more pressing than ever before.

Other Ministry publications which may assist farmers in this regard are "Taxation and the B.C. Farmer", "Farm Business Partnerships in B.C.", "Farm Business Corporations in B.C." and "Wills for the B.C. Farmer". From time to time issues relevant to this topic are addressed in the "Farm Business Management Factsheet" series also published by the Economics Branch of the B.C. Ministry of Agriculture and Food.

This publication was prepared by Derek Fryer, Chartered Accountant, a partner in McKnight, Johnson and Partners of Chilliwack and Abbotsford, B.C. Acknowledgement is also gratefully given to W. Maxwell, R. Newby, and John C. Lee of Baker, Newby & Company, Barristers and Solicitors, Chilliwack for their review of legal matters, and to Terry Peterson, Supervisor of Farm Business Management programs in the Ministry for his project leadership and review of content through several drafts of this publication.

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## INTRODUCTION

Perhaps the best way of introducing this publication is to review the script of an imaginary play about the manner in which a farming family deals with its estate. While the actors are fictitious, the sequence of events is fairly typical of what happens in real-life.

The stars of our play are John and Mary Brown who are both aged 57. They have been successful farmers throughout their lives and are now considering retirement in the next two or three years.

All of their assets are tied up in the farm and they have very little insurance. The farm is now being run by their son Bill, who is aged 35 and lives on the property with his wife and two children. He does not have an ownership interest at this time but "understands" that he will inherit the farm one day.

The parents also have two daughters who are married and not involved in the farming business.

In scene one, John and Mary chat about their future retirement while having dinner. It is not a particularly thoughtful discussion - merely a casual conversation about what might happen in the future. They have done this on several occasions in the past and have never involved their children. They have been told by their solicitor and accountant that they should be making an overall estate plan. Bill has also been encouraging them to do this because he would like to know where he stands. John and Mary realize that they should be doing something but always find a reason to put off a decision.

The one point that they seem to agree on is that Bill should acquire the farm because he has put a lot of work into it. The property was inherited from John's parents so they would like to see it continue in the family if possible. However, there remains the question of how they should deal with their daughters. They want to treat all of their children fairly.

John and Mary have prepared a straight-forward will. It provides that after the death of the survivor of them, all of their assets shall be divided equally among their children.

In scene two, John and Mary are killed in an automobile accident and the children suddenly find themselves in the position of co-owners of the farm. Soon there is disagreement as to how Bill might acquire complete ownership of the farm and because of the constant arguments there is a real possibility that there will be permanent damage to the family relationship.

In scene three, the family has split into bitter factions and the farm has been sold. Substantial income taxes have been paid on the gains that accrued during the parents' lifetime and Bill has been forced to move off a farm that has been in his family for three generations.

This scenario is unfortunate, but in real life there can be others which are just as bad or worse. Perhaps the parents do not prepare a will with the result that their property is distributed in accordance with the government's rules rather than in accordance with the parents' wishes. Alternatively, perhaps there is a will, but it is challenged by one or more of the children on the basis that it does not make adequate provision for them. There can be other problems too. Perhaps the parents deal with their farm property in such a manner that they are not able to transfer it to their children on a tax-deferred basis and their family is exposed to a substantial income tax liability.

The desire to avoid these and other estate planning problems is the reason that this book has been written. Hopefully, it will give the reader an insight as to how to approach estate planning.

The commentary is based upon the Income Tax Act as it stood on September 1, 1984 and incorporates the proposed changes to that Act which were included in the federal budget of the former Liberal government on February 15, 1984.

Throughout the book, the farmer is referred to as a man. This has been done only to make the writing style less cumbersome. The material is, of course, equally applicable to the many women who are involved in farming in British Columbia.

Unfortunately, there are many "technical terms" that must be used when explaining the legal and income tax implications of estate planning. The meaning of these terms is explained in the Glossary in the Appendices of this book.

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September, 1984

# CHAPTER 1

## THE BASICS OF ESTATE PLANNING

There is a certain reluctance in all of us to deal with the subject of estate planning because it requires us to consider what is going to happen after we die. Death is not a particularly pleasant subject and we prefer not to think about it. Some of this reluctance may disappear if estate planning is thought of in a broader context as having to do with the accumulation and use of property during one's lifetime, as well as its distribution after death. In fact, this is what it is.

Estate planning is particularly important to the farmer because he is part of a very capital-intensive industry. Based on information released recently by one of the Chartered Banks in Canada, it appears that the capital employed in the average farm in Canada increased by over 600% in the ten year period from 1971 to 1981. This rate of growth will no doubt be maintained as farmers continue to mechanize and expand the size of their units so as to operate more efficiently. The size of the farmer's estate, his potential exposure to income tax in respect of his accrued capital gains since 1971 and the fact that substantially all of his net worth is tied up in the farm create special problems for him that can only be dealt with through a well-constructed estate plan.

### What is estate planning?

Estate planning deals with all aspects of the accumulation, use and distribution of a person's assets. It therefore entails all of the following:

- accumulating and controlling assets;
- providing adequate retirement income;
- providing for an orderly and equitable distribution of assets during lifetime or on death;
- maintaining sufficient liquidity to pay taxes and other costs at death; and
- minimizing tax.

The farmer has a number of tools at his disposal which he can use to achieve all of the above. For instance, he can:

- prepare a will describing how property is to be distributed after his death (see Chapter 2);
- choose a form of business arrangement that minimizes his tax liability and facilitates the transfer of his property to his beneficiaries (see Chapters 3 and 6);
- transfer property during his lifetime or on death and use trusts to hold property for a spouse or child (see Chapter 4);
- plan his retirement income (see Chapter 5); and

- provide liquidity in his estate with the use of life insurance (see Chapter 7).

What are the benefits?

The time and effort spent on an estate plan is usually well-rewarded in terms of the savings in taxes, estate management costs and property transfer procedures. Equally important, however, is the peace of mind enjoyed by the farmer and his family in the knowledge that the plan has been well-thought-out and is fair to all.

When should the farmer begin to plan?

He should give some thought to estate planning as soon as he begins to accumulate assets. While he is single and relatively young, his planning will perhaps be restricted to the safeguarding of valuable assets (such as storing of valuable documents in a safety deposit box) and the preparation of a will setting out what should happen to his property in the event of his sudden death.

After he marries and starts a family the scope of his planning will broaden. He will change the beneficiaries in his will and perhaps name a person who would act as guardian to his children if he and his wife should die suddenly. His business affairs will probably become more substantial and he will want to assess whether any alternative form of organization would be beneficial. Perhaps he will want to form a partnership with his wife. His debts will probably be more substantial and he will want to reassess the extent of his insurance coverage.

Later on in life his estate plan will broaden even further because he will then have to decide how to bring his children into the business. Ultimately, he will have to consider his retirement plans and the disposition of his property. Plans may have to be changed periodically in response to external factors such as new government legislation.

It can be seen, therefore, that an estate plan is not something that is made and then forgotten. It is something that evolves throughout the middle years of a person's life and requires a periodic check-up in response to his changing circumstances.

How is an estate plan formulated?

The farmer's planning in the early years will probably centre around the managing of his farm and the earning of sufficient income to support his family. In later years, however, he will have different concerns such as:

- will any of his children want to take over the farm?
- if yes, how should it be transferred to them and what would the tax consequences be?
- how can the transfer be structured so that he receives sufficient retirement capital?
- how are his non-farming children to be provided for?

- does he have sufficient liquid assets?

The first step in dealing with these concerns is for the farmer to develop some estate planning objectives concerning the disposition of his property. This will not necessarily be easy. It is important for the farmer to discuss the matter openly with his family, perhaps over a considerable length of time. The decisions will not be made "overnight" - at least the correct ones will not be.

The farmer will have to wrestle with the questions of whether or not the farm can support the number of children who are interested in carrying it on and whether the equitable distribution of property among his children should be an equal one. Often it will not be. Sometimes the farmer will arrive at conflicting objectives. He may, for instance, want to transfer his farm intact to his son but, because he also wants to treat his other five children equitably and has few non-farming assets, he may be forced into breaking up the family farm.

If the farmer intends to bring one or more of his children into the business he will have to recognize that special arrangements will have to be made in the early years. The child's contribution of capital may be small yet his income requirements may be quite high because of the costs he must incur in raising a young family. A profit split based solely on their respective contributions of capital and labour may not meet the child's needs and may cause him to become discouraged.

One of the farmer's estate planning objectives should be to ensure that his retirement needs are provided for. This is an aspect that is often not given the attention that it deserves. The farmer will have to consider a number of questions, including the following:

- is it likely that the farm will be transferred to his children during his lifetime and, if so, how much retirement capital could it provide?
- will it be necessary to move off the farm?
- what non-farm income will he receive during retirement (pensions, etc.)?
- what will his other income requirements be?

After establishing his objectives the farmer should compile an inventory of his assets and then become familiar with some of the techniques for estate planning and the income tax rules applying on the disposition of farm property. He should do this by talking to his friends and neighbours and to the local Regional Farm Economist from the Ministry of Agriculture and Food. He might also review a publication on estate planning such as this one and the other publications issued by the Ministry of Agriculture and Food entitled "Wills for B.C. Farmers"; "Farm Business Partnerships in British Columbia"; "Farm Business Corporations in British Columbia"; and "Taxation and the B.C. Farmer". Finally, he should seek professional advice from his solicitor, qualified accountant and insurance agent.

After a plan is developed in draft form by the professional adviser, the

farmer should discuss it with his family. It is important that all members of the family know where they stand and believe that they have been fairly treated. Time spent at this stage can save much anguish after the farmer's death. It can also avoid the possibility of the plan being contested under the Wills Variation Act.

The farmer's accountant will naturally be concerned about minimizing his client's tax liability, but it must be recognized that tax is not the most important consideration. The farmer and his spouse must feel comfortable with the plan recommended to them and it must conform to their ideas on how they should deal with their children.

The estate plan should be flexible. It should, for instance, take into account that the farmer's children may change their personal goals and career paths. The farmer should not take irrevocable steps until he is certain that his children have decided what they want to do with their lives.

The farmer's wife should be acquainted with all aspects of the business. She should be aware of the location of the important documents and records so that if the farmer were to die suddenly she would know what has to be done.

An important ingredient of the estate plan will be the maintenance of adequate financial records. The farmer should maintain a record of his major assets, insurance policies, bank accounts, etc. and should keep them in a safe place together with his other valuable papers. The schedules in the Appendices of this publication may be helpful to the farmer in this respect.

## Gift tax and succession duties

The farmer in British Columbia has to consider the effect of income taxes on his estate plan but, fortunately, he does not also have to wrestle with gift taxes and succession duties. These taxes were abolished in British Columbia in January 1977 and have now been eliminated in all other provinces except Quebec. Nowadays, therefore, a B.C. farmer need not be concerned about the possibility of a gift tax if he should transfer property or cash to a member of his family.

## CHAPTER 2

## WILL-PLANNING

### Introduction

One of the most important documents that a farmer executes during his lifetime is his will. Ideally, it is just one of the key elements in his overall estate plan but in some situations it represents the only estate planning that he does. It may have far-reaching effects on his family and business partners so it should be given a lot of consideration. A solicitor should always prepare the document in order to avoid potential problems.

Will-planning is important both for the farmer and his spouse. Very often the farm is owned by them jointly and their respective interests in the property pass to the survivor on the death of the first spouse.

The will is a legally enforceable document that can be altered or revoked during the farmer's lifetime, so long as he has testamentary capacity, and becomes effective only on his death. It describes his wishes regarding the distribution of his property and the appointment of executors. It may also deal with other matters such as the appointment of trustees to hold property in trust for his surviving spouse and for children and the appointment of guardians for his children.

A person loses his testamentary capacity when he is no longer able to understand the nature and effect of particular documents. This might happen for instance, if he were to have a stroke. Because there is always the possibility of this occurring without warning it is important that will-planning be updated regularly.

All farmers should prepare a will to ensure that their property is distributed in an orderly manner to their family and friends, in accordance with their wishes. If they fail to prepare one, their assets can only be dealt with in accordance with the provisions of the Estate Administration Act (see later discussion). This can result in additional worry for the farmer's family, a possible delay in the distribution of his estate and the exclusion of some persons from sharing in his assets that he would have wanted to benefit. In some instances, there may even be a loss of an income tax "rollover" on the transfer of property to a child thereby causing the estate to be exposed to a substantial tax liability.

In planning his will the farmer should take into account many factors including the provisions of buy-sell agreements entered into with his business partners, the income tax rules applying on death, the amount of liquid assets in his estate, the manner in which he holds his business assets and the provisions of any marriage agreement. Because these considerations are complicated and they change periodically, the farmer should get into the habit of obtaining professional advice and reviewing

his will-planning every three or four years. There should always be a review after the following:

- a major change in business arrangements (e.g. formation of a company or partnership);
- a beneficiary emigrates from Canada;
- major changes in the form or mix of assets;
- major succession duty or income tax changes;
- birth or death of a child or grandchild;
- divorce; or
- death of an executor, spouse or other named beneficiary.

In deciding the terms of his will, the farmer should thoroughly discuss his estate plans with his family. There should be no surprises after his death and his family should be prepared for what is to happen at that point. This discussion can take a considerable length of time and may be assisted by the involvement of professionals such as the family solicitor and accountant, an insurance agent and perhaps the local farm economist from the Ministry of Agriculture and Food.

After the will is completed and signed, the farmer should leave the original with his solicitor for safe-keeping and should keep a copy for his own records. It may be appropriate to also provide a copy to his accountant and executor.

Legal formalities

The formalities governing the making of a conventional will are contained in the Wills Act of British Columbia. This Act provides that the document must be in writing and must be signed by the person making it (the testator) or by some other person in his presence and under his instructions. The testator should sign his will in the presence of two or more witnesses who should be over the age of majority and should not be beneficiaries named in the will, nor the spouses of those beneficiaries. This latter point is extremely important. If bequests are made to the witnesses of a will, or to their spouses, they will be forfeited and the property will simply form part of the residue of the deceased's estate.

If there is more than one will, the last one over-rides the earlier versions. For this reason, it is important that the will be dated.

Generally, a person must be nineteen years of age or older before he can make a will although, a married infant (a person under age nineteen) or a member of the Canadian forces can prepare one irrespective of his age. The person must have the mental capacity to prepare the will and must not be forced or coerced into it.

A will may be revoked by making a new one, by destroying or revoking an existing one or by the marriage of the testator. (A divorce will not revoke a will but it will have the effect of cancelling transfers of property to the ex-spouse and the appointment of him or her as executor or

trustee.) A testator need not necessarily make a new will each time he wants to change it. He may be able to make the change by simply attaching a "codicil".

If a farmer prepares or updates his will shortly before his marriage, he should record in the document that it is being prepared or updated in contemplation of marriage. This evidences that he was aware of his upcoming marriage at the time the will was prepared and the marriage itself will not then have the effect of revoking it.

Who should act as executor?

The farmer will generally want to have his spouse and/or his children act as executors. The decision as to who should be involved will depend on the complexity of his business arrangements and the ability of his spouse and children to deal with them.

If the will establishes a trust for the farmer's spouse under which income from the farm passes to her during her lifetime and the farm property passes to their children on her death, it might not be a good idea for the spouse to act as the sole executor. One or more of the children might also be appointed so that there is a proper balancing of the interests of the spouse and the children. If the will empowers the executors to augment the spouse's income by selling assets of the trust, it is usually preferable to also have independent executors so that the children are not placed in the awkward position of trying to decide whether a sale should be made.

In some situations, it may be appropriate to have a friend or business associate act as an executor. The farmer should ensure, however, that the business associate is not put in a position of conflict. This might happen if farm assets are to be sold by the estate and the business associate might be one of the buyers.

Some farmers have named their solicitor or accountant to act as one of the executors. These persons may be good choices if they have a detailed knowledge of the testator's affairs and beneficiaries, and can afford to spend the appropriate amount of time on estate administration. Often, their other commitments prevent them from doing this and the farmer is better off to retain these individuals in their professional capacities rather than as executors.

A trust company may be useful in situations where the farmer has extensive business interests or a trust is to be created that will exist for a long time. It can provide a full service administration package that can rarely be equalled elsewhere. However, the trust company will not always have an office in the area in which the farmer lives and this can complicate the administration of the estate. The trust company may also be more costly.

Provisions in the will

The testator should specify the manner in which his estate is to be

distributed. The distribution may be in the form of a specific bequest, a general bequest or a share of the residue of the estate.

A specific bequest is made where a specific property such as an interest in a particular corporation or a specific parcel of land is left to a beneficiary. If the particular property is sold before the testator's death, the beneficiary may lose his inheritance unless he also shares in the residue of the estate.

A general bequest refers only to a sum of money rather than to a particular property. If the testator's debts exceed the residue of his estate, the excess will be applied on a pro-rata basis against these bequests.

The testator will usually specify what is to happen to his debts. They may be assumed by one of the beneficiaries or be paid out of the residue of the estate.

Property passing to the testator's spouse may be transferred directly to her or to a trust for her benefit. Use of a trust will ensure that the future entitlement of their children cannot be affected by a second marriage of the surviving spouse. The testator may also use a trust to hold property for infant children.

There is usually a provision setting out what should happen in the event that the testator and his spouse are killed in a common accident. If there is no such provision, the younger of the two is deemed to survive the other and the distribution of the two estates is processed accordingly. Sometimes the will also provides that the bequest to a spouse shall not take place unless he or she survives the testator by at least 30 days.

The testator may consider giving his children the right to acquire certain property from his estate at a percentage of its fair market value. He should realize that this provision will have the effect of removing the "tax rollover" that might otherwise have been available. This is discussed further in Chapter 10.

If certain assets are to be distributed "in specie", the testator should ensure that the will gives the executor the power to do this.

Property not forming part of the estate

Property held in a joint-tenancy arrangement (see Chapter 3), together with the proceeds of insurance policies and registered retirement savings plans for which there are named beneficiaries, do not form part of a deceased's estate and accordingly, are not affected by the terms of his will. These assets pass directly to the surviving joint tenants or to the named beneficiaries, as the case may be, and are not available to the deceased's creditors. Farmers should check their old insurance policies and registered retirement savings plans to ensure that the "beneficiary designation" is still appropriate.

Because of recent changes to the Income Tax Act, the farmer will generally want to designate his spouse as the named beneficiary of his registered retirement savings plan. This is discussed in Chapter 5.

## Wills Variation Act

The farmer should be aware that even where he provides for the disposition of his property in a properly-drawn will, the Wills Variation Act in British Columbia may enable his wishes to be varied or set aside by a court if it determines that he has not made adequate provision for his wife and children. Some provision is not necessarily adequate provision. This possibility is sometimes of concern to a farmer because his assets are not always divided equally amongst his children. In some situations, the desire to keep the farm intact and to treat all children equitably, not necessarily equally, means that the inheritance of some children is larger than others.

Disputes can be avoided if the farmer discusses his estate plans with his family and obtains their approval. Where one of the children appears to be treated on a more favourable basis, perhaps because of previous contributions to the farm for which he has not been paid, it is probably advisable for the farmer to include his reasoning in his will. Then, if the matter is contested after his death, the court will be able to take this reasoning into account.

If one or more children are to receive more than their pro-rata share of the estate, it may be advisable for the farmer to arrange for the transfer of the extra share during his lifetime. In this manner, he might avoid potential problems under the Wills Variation Act. He may gain other benefits as well because, generally speaking, the transfer of farm property during one's lifetime can be an excellent method of distributing the estate. Obviously, this is a matter that the farmer should discuss with his solicitor, and perhaps his accountant, when preparing his estate plan.

## What happens if there is no will?

If a farmer dies without making a will, the intestacy rules in the Estate Administration Act in British Columbia come into effect. These rules state that no one has authority to deal with the deceased's assets until an administrator is appointed by the court. This can be an expensive and cumbersome procedure.

The manner of distributing an intestate's assets will depend on the relationship of the persons who survive the deceased. If the intestate leaves a spouse and children, the home and furnishings and the first $65,000 of the other assets pass to the spouse and the remainder is allocated between the spouse and children. The spouse receives one-half of the remainder where there is only one child and one-third where there is more than one child. If the intestate is survived only by his children, the entire estate is divided between them on an equal basis.

Attached as an appendix to this publication is a schedule describing the manner in which assets are distributed on an intestacy in different situations.

As will be discussed in Chapter 4, there are rules in the Income Tax Act that allow certain farm property to be distributed on death from one generation to the next, on a tax-deferred basis (called a "rollover"). These rules apply only where the property vests indefeasibly in the beneficiary within a certain time period following the date of death. (The term "indefeasibly" means, in effect, that the right of ownership cannot be defeated by a future event.)

Where there is a will, the rollover will generally be assured because the property passing to the farmer's children is deemed to vest in them on death. Where, however, there is no will, the situation is not as clear. Based on a recent court decision each child may be able to argue that his minimum entitlement under the Estate Administration Act vested in him at the date of death. He may not be able to meet the vesting requirement in respect of any additional property he might receive beyond this minimum entitlement.

## CHAPTER 3

## SIGNIFICANCE OF BUSINESS ARRANGEMENTS

### Introduction

The manner in which a farmer organizes his business interests can have a significant impact on his estate plan. His land, for instance, might be owned outright or might be co-owned in the form of a joint tenancy or tenancy in common. These alternate forms of ownership can affect his ability to deal with his land through his will.

The farmer's business might be carried on by a proprietorship, partnership, corporation or trust. These different arrangements can have a substantial impact on the manner in which he operates his business, the income taxes that he will pay during his lifetime and the form in which his children will receive their inheritance after his death.

### Co-ownership - Joint tenancy and tenancy in common

A joint tenancy is an arrangement under which two or more persons hold an undivided interest in property. The characteristic that distinguishes it from other forms of co-ownership is the inability of the joint tenant to dispose of his interest in the property through his will unless he severs the joint tenancy before his death. On death, the joint tenant's interest automatically passes to the other joint tenants.

This "survivorship" characteristic does not prevent the joint tenant from dealing with his interest in the property during his lifetime. He can transfer this interest to strangers, or to his joint tenants, in the same manner that he deals with other interests in property.

A farmer and his wife will often hold property as joint tenants because they intend that their respective interests shall pass to the survivor of them on their deaths. However, business partners will generally not hold their property interests in this manner because they will want to control the distribution of their property after their death.

A tenancy in common is also an arrangement under which two or more persons hold an undivided interest in property. As with a joint tenancy, each co-owner has an equal right to possession of the property because the property has not been divided in a specific way. Unlike a joint tenancy, however, the ownership interest of a co-owner under a tenancy in common need not be equal to that of his co-owners. For instance, a tenant under a tenancy in common arrangement could hold a 90% interest in a particular property and his co-owners could hold the remaining 10%.

Property owned under a tenancy in common arrangement does not pass to the co-owners on the death of the tenant. It falls into the tenant's estate and is disposed of in accordance with his will, just like any other

property.

Land owned by a partnership should be registered jointly in the names of the partners. Ordinarily, it would be held in the form of a tenancy in common and not a joint tenancy.

If a farmer, owning a property outright, transfers an interest in that property to another person so that he then holds the property as a co-owner, or if he transfers part or all of his co-ownership interest to another person, he will be treated as having disposed of the property for income tax purposes. The property will be deemed to have been disposed of at fair market value unless one of the rollover rules apply (see Chapter 4). The farmer should, therefore, be careful if he is considering a change in the manner in which his property is registered.

Sole Proprietorships

The farmer who is a sole proprietor usually owns all of his farming assets directly, or jointly with his spouse, and is able to transfer them during his lifetime or through his will. In some situations, the farm is co-owned with his spouse in a joint tenancy and will automatically pass to her on his death.

The transfer of a sole proprietorship to the next generation may be time-consuming and cumbersome because each asset will have to be identified and dealt with. However, for many farmers, the simplicity and flexibility that the sole proprietorship offers during their lifetimes more than compensates for this problem. Moreover, there is an intangible benefit in that the direct ownership of the farm is more in keeping with their emotional attachment to the land.

The sole proprietorship allows the farmer to operate his business in a reasonably tax-effective manner. This is important, because the minimization of tax is an integral part of any estate plan. Admittedly, the proprietor in British Columbia is subject to tax on his farm profits at marginal rates which vary from nil to approximately 50% but there are a number of offsetting advantages. He can, for instance, use block averaging and forward averaging, he can claim the principal residence exemption on the sale of his farm, he can issue a small business bond if he is in financial difficulty and he can offset his farming losses against other income without restriction provided he is considered to be a full-time farmer and is not caught by the restricted farm loss rules. He can also offset business or property losses and up to $2,000 of the excess of allowable capital losses over taxable capital gains against farming income.

Farmers who wish to review these aspects further should read "Taxation and the B.C. Farmer" published by the Ministry of Agriculture and Food in British Columbia.

The sole proprietor has considerable flexibility in distributing his farming assets to his children in a tax-effective manner. There are also

extensive "rollovers" available in respect of farm property transferred to a spouse or to a spouse trust and to property transferred from a spouse trust to a child. These are discussed in Chapter 4.

## Partnerships

The farmer who is a partner in a farming partnership is in a different position than the sole proprietor. Even though certain partnership assets such as land may be registered jointly in the name of the farmer and his partners, and it will be necessary to change this registration when the farmer dies or disposes of his interest in the partnership, the Income Tax Act does not consider the farmer to be the owner of the individual assets in the partnership. Rather, the partnership is considered to own them and the farmer is considered to own a "partnership interest" in much the same manner as he might own shares in a corporation. When he dies, he is deemed to have disposed of this partnership interest and not his interest in the individual assets.

The farmer who enters into a partnership should remember that he becomes jointly and severally liable for all of the partnerships debts. So he should choose his business partners carefully.

In terms of his ongoing exposure to income tax, the partner in a farm partnership is in much the same position as the sole proprietor. Farmers who wish to review the tax rules applying to partnerships should review "Farm Business Partnerships in British Columbia", a publication issued by the Ministry of Agriculture and Food in British Columbia.

Because a partnership is treated for tax purposes as being an entity that is separate from its partners, care must be taken in transferring assets to a partnership or receiving assets from it. Generally, these transfers are deemed to take place at fair market value unless special elections are filed with Revenue Canada within a prescribed time limit. This area is discussed in "Farm Business Partnerships in British Columbia", referred to earlier.

The partner who has an interest in a farming partnership has considerable flexibility in distributing his interest to his children and his spouse in a tax-effective manner. This is discussed in Chapter 4.

## Corporations

Corporations are treated under corporate and income tax law as being entities which are separate and distinct from their shareholders. When a farmer transfers his interest in a corporation to his spouse or child, it is only necessary to amend the corporation's share records. The transfer is therefore extremely easy. The corporation can provide continuity for the farming operations. The corporation might be passed from one generation to the next but the operation of the farm will continue unaffected.

The farmer who incorporates his farm will no longer be able to block

average. Furthermore, he will have to pay increased attention to the proper segregation of his personal and business funds. Because the corporation is a separate entity for tax purposes and there are rules in the Income Tax Act that restrict it from making loans or advances to its shareholders, there will have to be a careful accounting of the shareholders' draws and personal expenses, and these amounts will have to be repaid or covered off by the payment of a salary or dividend.

Most farm corporations are taxed at the rate of only 23% on the first $200,000 of taxable farm income each year. Presently, this low rate continues until the corporation has, in total, earned $1,000,000 of such income.* There is a further tax applicable to dividends paid out of income taxed at 23%; however, because this tax is not payable until the dividends are actually distributed, it is possible for a successful farmer to obtain significant tax deferrals by the use of a corporation. This and other aspects of the taxation of corporations and their shareholders are discussed in "Farm Business Corporations in British Columbia", another publication of the Ministry of Agriculture and Food.

The shareholder of a farm corporation has considerable flexibility in distributing his share interest to his children or spouse on a tax-deferred basis. This is discussed in Chapter 4.

Trusts

A farmer will not often use a trust arrangement because he prefers to keep his affairs uncomplicated and pass absolute ownership of his farm to his spouse or children. There will be situations, however, where the farmer may not want to bequeath his farm directly to his spouse, so that she can dispose of it in her lifetime or in her will, but may prefer to bequeath it to his children in such a manner that his spouse can receive all of the income from the farm during her lifetime. This can be achieved through a trust and it ensures that his children cannot be cut out of his estate if his surviving spouse marries again. A farmer may also want to consider the use of a trust in the event that he should die unexpectedly and property should pass from his estate to a child who has not attained the age of majority.

A farmer may inherit a trust arrangement. One of his parents may have placed farm property in a trust with the stipulation that it should remain there until both parents die. The farmer may perhaps manage the farm and be paid for his work but during the lifetime of his surviving parent, the overall control of the farm will remain with the trustee of the trust.

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* *The former Liberal government proposed in its February 15, 1984 Budget that this $1,000,000 limitation be removed. This change is to be effective for taxation years ending in the calendar year following the calendar year in which the proposal is enacted into law.*

The farmer is the capital beneficiary of the trust because at some point he will acquire ownership of the farm. The surviving parent is the income beneficiary.

Property passing to a trust becomes the property of the trustee. The terms of the trust agreement will determine the manner in which he is able to deal with it.

A trust determines its income for tax purposes in much the same manner as any other person. The major exception is that it can deduct the income that is paid or payable to its beneficiaries. The amount deducted is included in the income of the beneficiaries. In certain types of trusts, the trustee and the beneficiaries can file a special income tax election (a preferred beneficiary election) which has the effect of deeming the income accumulating in the trust to be the income of the beneficiaries, even though it is not paid or payable to them. This income is then taxed in the beneficiaries' hands and not in the trust.

A trust created through the will of a farmer (called a testamentary trust) will generally pay tax on its income at the marginal rates applying to individuals. A trust created by a farmer during his lifetime will generally pay tax at a flat rate of approximately 50%.

Property passing into or out of a trust may be treated for income tax purposes as having been disposed of at fair market value. There will be deemed dispositions in other situations as well. Because of this, a farmer must seek expert professional advice if he contemplates using a trust arrangement.

In certain circumstances, a farmer is able to use a trust arrangement to transfer farming assets to his spouse and then to his children on a tax-deferred basis. This is discussed in Chapter 4.

## Conclusion

As mentioned in the introduction, the manner in which a farmer holds his business assets can have a significant impact on his estate plan. Before changing the existing arrangements he should obtain advice from his accountant and solicitor in order to avoid potential tax and legal problems.

## CHAPTER 4

## TRANSFER OF THE ESTATE DURING LIFETIME AND ON DEATH

### Introduction

The transfer of the farmer's estate is the culmination of his estate plan. If the plan has been well thought-out, and circumstances permit, the farmer will have accumulated sufficient capital for his retirement, he will have provided adequately for his spouse, he will have dealt equitably with his children and he will have arranged for a tax-effective transfer of his farm to the next generation.

The manner in which he accomplishes this may vary from one situation to the next. No two situations are alike because there are always personal requirements, relationships and feelings that are unique to the family concerned.

The techniques the farmer utilizes in transferring his estate are those discussed in this chapter. The manner in which he uses them will be determined by his estate planning objectives.

### SALES DURING THE FARMER'S LIFETIME

#### Why consider them?

The farmer may consider the sale of his farm property for different reasons. For instance, his children may not be interested in farming and he may therefore be obliged to sell his farm assets to a person outside the family when he retires. Alternatively, he may wish to sell all or a part of his farm to his "farming children" so as to provide capital that he can use in his retirement and a pool of non-farming assets that he can leave to his other children who will not be involved in the farm.

He may wish to sell farm assets to his child simply because he believes that it would be wrong to gift them to the child. Ultimately, his child may inherit all or a portion of the funds that he will pay for the farming assets but, in the meantime, he will have purchased the farm and the farmer may consider the child to be a better farm manager as a result.

If this arrangement results in the payment of income taxes, and there are alternatives that would enable the farmer to avoid this tax and still achieve his financial objectives, the farmer's accountant may try to persuade him to change his mind. He should remember, however, that the avoidance of tax is not always the most important consideration. An estate plan should not be followed unless the farmer is comfortable with it and it conforms to his beliefs as to how a parent should deal with his children.

As we will discuss later, the farmer is able to sell his farm assets to his children at less than fair market value. If the farmer decides to do this he should consider carefully whether the proposed sale proceeds will provide him with sufficient retirement capital. He should take into account the possible impact of inflation and the pensions and other income that he will receive during his retirement.

A sale to the children during the farmer's lifetime ensures that the property reaches the intended beneficiary. Arrangements can be made for the farmer and his spouse to remain on the farm and assist in the running of it so that the transition from active farming to retirement is a gradual one.

## Mortgage or agreement for sale?

When the farmer sells his farm and takes back debt on the transaction, he can structure the arrangement as an agreement for sale or he can secure the amount owing to him by having the purchaser grant a mortgage. If the contract is structured as an agreement for sale, title to the property remains with the farmer until the debt is repaid. If a mortgage is used, title passes to the purchaser and the farmer takes back the mortgage as evidence of the debt. If there is a default under the agreement for sale or mortgage, the farmer has the right to commence court action for the cancellation of the agreement for sale or the foreclosure of the mortgage.

The agreement for sale or mortgage will set out the repayment terms of the debt and the interest rate that will apply. If the farmer sells to a child he will have to take into account the ability of the farm to generate the payments that are provided for in the agreement as well as his own needs. If the child will have difficulty in making the debt repayments, the farmer may decide to accept a low interest rate or may even agree to charge no interest in the first few years of the agreement. Quite often, there will be an acceleration clause that will require the agreement for sale or mortgage to be repaid if the child sells the property.

## Income tax rules applying on sale of farm property

The tax arising on the sale of farm property will depend on the nature of the asset. If the property is a capital asset such as land, buildings, equipment, shares in a farm corporation or an interest in a farm partnership, there will be a capital gain to the extent that the sale proceeds exceed the total of the "adjusted cost base" of the property (see Glossary) and the costs of disposition. One-half of the capital gain (called the taxable capital gain) is included in the seller's income.

If the property is buildings, machinery or equipment depreciated for income tax purposes on the reducing balance basis, the depreciation claimed in previous years will be included in the farmer's income in the year of sale (i.e. "recaptured") to the extent that the lower of the sale proceeds and the original cost exceeds the undepreciated capital cost. If the asset was acquired before 1972 and depreciated for income tax purposes

on the straight-line basis there is no recapture of prior years' depreciation. If the farmer takes back debt on the sale, no portion of the recaptured depreciation is deferred for income tax purposes.

Where the sale proceeds of property depreciated on the reducing balance basis in a particular tax class are less than the undepreciated capital cost of the property, and the farmer has no other property of that class, the excess will ordinarily be deductible from the farmer's income as a "terminal loss". This deduction will be restricted, however, if the loss relates to a building and the land on which it is situated is sold at a profit.

If the property is quota, or any other government right or intangible asset, and the farmer disposes of all such assets, one-half of the proceeds are taken into income. The farmer is then able to deduct from income the balance of his undepreciated expenditures for such assets. This balance (called the cumulative eligible capital) will represent one-half of the original expenditures after 1971, less amounts written off for income tax purposes in previous years and less one-half of the proceeds of previous sales after 1972. If some of the quota sold was owned at December 31, 1971 (V-day), the formula for calculating the gain on sale will take the V-day value of such quota into account.

The Canadian courts have determined that under current income tax law, there is no inclusion in income in respect of the sale of quota or other intangibles until the sales proceeds are received. A farmer may use this factor to defer income tax arising on the sale.

If the property is livestock or feed and the farmer uses the accrual basis of accounting for tax purposes, the sale proceeds will be included in the farmer's income in the year of sale whether or not he receives the full sale proceeds in that year. If the farmer uses the cash basis of accounting for tax purposes, he only has to report as income in the year of sale the actual proceeds he receives during the year. Proceeds not reported in the year of sale are reported in the year they are actually received.

If the farmer sells all of his livestock, he will be able to write off the balance of his basic herd, if any, and, if he is on the cash basis of accounting, he will also be able to deduct the livestock adjustment that he included in his income in the year preceding the year of sale.

Claiming of reserves in respect of the unpaid sales price

A farmer may claim a reserve in respect of the unpaid sale proceeds when computing the capital gain arising from the sale of assets such as land, buildings, shares of farm corporations, partnership interests, etc. Originally, this reserve was intended to spread the tax liability over the period in which the unpaid sales proceeds were collected. However, as a result of rules introduced into the Income Tax Act in 1981, the reserve cannot be claimed for a period in excess of ten years (five years if the transferred property is other than farm assets (as defined) and five years

if farm assets are transferred to a person other than the farmer's child).

In Appendix 5 there is an illustration of how these rules work.

Planning the sale

Whether the farmer is selling to his children or to a stranger, there may be steps that can be carried out at the time of the sale to reduce or defer the income taxes that will arise. For instance, the sole proprietor with a non-calendar year-end may want to enter into the sale immediately after his year-end and before the end of the calendar year. Taxable capital gains arising from the sale would then be taxed in the calendar year in which the assets are sold whereas recaptured depreciation and income arising from the sale of livestock, inventories and quota would be taxed in the following year.* Splitting the income in this manner may reduce the overall tax bite.

To the extent possible, the sale should be planned so that the farmer benefits from block averaging. Since block averaging is available only every five years, a farmer contemplating the sale of his farm in two or three years should be careful not to use this provision for the sake of saving a few hundred dollars of tax currently when it might have been used to save several thousands of dollars in the year of sale.

The farmer should also give consideration to the manner in which the sales consideration (e.g. cash and debt) is allocated to the various assets sold. This may affect the reserves that he can claim and the timing of the recognition of income. These and other matters are discussed in greater detail in "Taxation and the B.C. Farmer", published by the Ministry of Agriculture and Food in British Columbia.

It should be noted that all of the above are matters to be taken into account before the sale. It is important, therefore, that the farmer seek professional advice well in advance of the proposed sale date.

Purchase of a replacement farm

Upon retirement, a farmer will sometimes sell the family farm and buy a scaled-down operation to keep him busy during his retirement years. Depending on the amount paid for the new farm and the timing of the purchase, it is possible that he will be able to defer some of the income tax arising on the sale of the original farm by taking advantage of the

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* *The former Liberal government proposed in its February 15, 1984 budget that farmers be able to shelter from tax the taxable capital gains arising from the sale of certain farm properties owned at December 31, 1983 by making a special contribution to a registered retirement savings plan. This proposal is explained on page 35 of Chapter 5.*

replacement property rules in the Income Tax Act. These rules are described in the booklet called "Taxation and the B.C. Farmer", published by the Ministry of Agriculture and Food in British Columbia.

Special income tax rules applying to sales to children

Generally, when a taxpayer transfers assets to his children during his lifetime (an inter-vivos transfer) the transfer is deemed to take place at fair market value. If the transfer price is less than fair market value, there are rules in the Income Tax act that allow Revenue Canada to make an adjustment to the vendor's income without necessarily allowing a corresponding adjustment to the purchaser.

There are important exceptions to this fair market value rule in respect of certain farming assets transferred by an individual to his child. These exceptions have been made because of the capital-intensive nature of farming and the particular importance that has been given to the continued prosperity of the family farm in Canada. If each generation were required to account for tax on all the recaptured depreciation and inflationary gains realized on farm properties during the period it owned them, family farms would probably not survive. In many cases, substantial assets would have to be sold each time the farm passed from one generation to the next so that the family could pay its tax liability.

The concession that has been made to farmers is to allow them to choose the value for income tax purposes at which certain farming assets (referred to as qualifying farm properties) may be transferred during their lifetime to their children. The transfer value that is selected by the farmer and his child will determine the income tax consequences to the farmer and the cost of the acquired properties to the child.

The ability to select the transfer price on qualifying farm properties is important because it gives the farmer the option of setting the price so that the income recognized for tax purposes is just sufficient to absorb his farm losses, low rates of income tax or unutilized tax credits.*/**

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* *The former Liberal government proposed in it budget of February 15, 1984 that where a child has acquired a qualifying farm property from a parent, and the child dies after 1983, the property may generally be transferred back to a parent at any value between its "cost amount" (see Glossary) and its fair market value.*

** *The former Liberal government also proposed that a farmer be able to defer tax on the taxable capital gains arising from the sale of certain farming properties owned on December 31, 1983 by making a special contribution to a registered retirement savings plan. This proposal is discussed on page 35 of Chapter 5.*

## Transfer of the Estate during Lifetime and on Death

The qualifying farm properties that are eligible for the tax-deferred transfer and the range of transfer prices that can be selected is as follows:

TRANSFERS TO CHILDREN [3]

| Property | Lowest Transfer Value [1] | Highest Transfer Value |
|---|---|---|
| Land [2] | Cost Amount (See Glossary) | Fair Market Value |
| Buildings, equipment etc. depreciated on the reducing balance basis [2] | Cost Amount (See Glossary) | Fair Market Value |
| Eligible capital properties (e.g. quota) [2] | 2x Cost Amount (See Glossary) | Fair Market Value |
| Shares in a family farm corporation (See Glossary for definition) | Cost Amount (See Glossary) | Fair Market Value |
| Interest in a family farm partnership (See Glossary for definition) | Cost Amount (See Glossary) | Fair Market Value |

Notes

1. Generally, the selected transfer value cannot be less than the total of the debt assumed by the child and the amount he agrees to pay to his parents.

2. The property must be owned by the farmer directly and, immediately before the transfer, it must be used by him, his spouse, or any of his children in the business of farming in Canada.

3. The term child includes a grandchild, great grandchild, daughter-in-law, son-in-law, adopted child, stepchild, an illegitimate child and certain other persons.

It is important to note that the farmer's accrued tax liability is not avoided - it is simply deferred. The liability is passed to the next generation together with the farm property.

Revenue Canada takes the view that the tax-deferred transfer (or rollover) does not apply to the farmer's principal residence located on the farm. However, the gain on the sale of the residence will often be exempt from tax under the general principal residence rules or will be taxed at a nominal amount because of the special rules applying to farmers' residences.

Under the current income tax law, land and buildings which are rented to a

farm corporation will not be considered to be used in the business of farming by the farmer, his spouse or children and will therefore not be eligible for a tax-deferred transfer (or rollover) to a child. Property rented to a partnership may also not qualify although Revenue Canada has stated that it will treat the property as qualifying property provided that the only members of the partnership are the farmer, his spouse, or any of his children.*

Revenue Canada has issued an Interpretation Bulletin (IT - 268R2) dealing with the inter-vivos transfer of farm property to a child. This Bulletin states that although the Income Tax Act requires that the qualifying property be transferred directly to a child the Department will, under certain conditions, permit the rollover to apply if the property is transferred to a trust for the benefit of a minor child. The Bulletin also states that a rollover will be permitted if the property passes to a partnership where all the partners are the taxpayer's children.

It is to be noted that the qualifying property of a sole proprietor does not include his livestock and inventories or his depreciable property that is written-off on the straight-line method. These assets, if disposed of during the farmer's lifetime, must be transferred to a child at fair market value. Consideration should be given to converting "straight-line" depreciable assets to "reducing balance" assets prior to a transfer to a child in order to effect the transfer on a tax-deferred basis.

The farmer who carries on his farming business through a partnership or a corporation may achieve a more complete rollover of farm property to his children. Remember that, where the farm assets are held by a family farm partnership or corporation, the farmer does not have direct ownership of those assets but rather holds only a partnership interest or shares. This partnership interest or the shares in the corporation as the case may be, will be eligible for a complete rollover provided that the partnership qualifies as a family farm partnership (see Glossary) or that the corporation qualifies as a family farm corporation (see Glossary). The use of a corporation or partnership effectively allows a farmer to transfer to his child on a rollover basis his cash basis inventories and his depreciable property depreciated on a straight-line basis.

Attribution of income to the farmer

If a farmer transfers qualifying farm property to a child under the age of

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* *The former Liberal government proposed in its February 15, 1984 budget that property leased by an individual to his family farm corporation (see Glossary) or to a family farm corporation or partnership (see Glossary) of his spouse or child be treated as property used in the business of farming for purposes of these rollover rules. This change is to be effective for property transferred after December 31, 1983.*

18 on a rollover basis, taxable capital gains or allowable capital losses arising from the disposition of that property will generally be attributed back to the farmer and included in his income, unless the child attains the age of 18 before the end of the year in which the disposition takes place.

Forgiveness of debt

If a farmer sells qualifying property to his child at a stipulated value and subsequently decides to forgive a portion of the debt arising on the sale, the farmer and his child may be exposed to a double tax. They would have been better off to sell the property at a reduced value in the initial transaction.

To illustrate, let us assume that a farmer holds qualifying property, say land, worth $180,000 with an adjusted cost base of $100,000, and decides to transfer it to his child for $150,000. The child makes a down payment of $30,000 and issues a mortgage for $120,000. Subsequently, the father decides to increase the gift to his child and forgives $50,000 of the debt owing by him.

The consequences of this are as follows:

1. The father will be taxed on the taxable capital gain of $25,000 realized on the original sale (1/2 x $150,000 - $100,000);

2. The forgiveness of debt will reduce either the child's loss carry-forwards or the tax values of his depreciable property or capital property by $50,000 (section 80 of the Income Tax Act); and

3. Assuming the adjusted cost base of the child's land is reduced (see 2 above), the accrued gain on the property at the date the father transferred it to his child ($50,000) will be taxed a second time when the child sells the property.

If the land had been sold originally for $100,000, which could have been arranged because it is qualifying property, the consequences would have been as follows:

1. There would have been no taxable capital gain on the original sale;

2. The child would have inherited his father's accrued capital gain and would have paid tax on it when he sold the property and realized the gain; and

3. There would have been no double tax.

There would not have been a problem in this hypothetical situation had the

father decided to forgive $50,000 of the debt through his will. In that situation, Revenue Canada has stated that it will not reduce the child's loss carry-forwards or the tax values of his capital property.

## GIFTS DURING THE FARMER'S LIFETIME

### Why consider them?

If a farmer has sufficient retirement capital, he may want to consider gifting farm property to a child rather than selling it to him. Perhaps the farmer recognizes that his child will have difficulty making "ends meet" in the first few years of his farming business and the removal of debt servicing costs on particular assets may make a considerable difference. Perhaps the child has earned the "gift" as a result of the contribution he has made to the family farm in previous years for which he has not been appropriately remunerated.

A farmer who has sold a substantial portion of his farming assets may want to consider the gifting of liquid assets to his children (e.g. cash ) as a form of income-splitting within the family.

If a gift is made to one of several children, the farmer may want to view it as being a payment on account of the distribution that the child will receive on the farmer's death. This can be accomplished through the farmer's will by placing a value on the gift and stating that the other children should receive an equivalent distribution out of the estate before the residue is divided among all the children.

The farmer may want to transfer property to his spouse if she is to become involved in his farming business.

### Implications of making gifts

A gift of cash has no tax implications except that if the gift is made to a spouse, or to a child who is a minor, the "income attribution rules" may have the effect of causing the farmer to be taxed on the income earned by the spouse or child on the funds gifted to them. These rules are discussed in Chapter 5.

Property other than cash that is gifted from one person to another is generally considered to be disposed of at fair market value and the person making the gift has to account for the income tax that is payable. There are some important exceptions, however, in respect of properties transferred to a child or a spouse.

Qualifying farm properties (see Glossary) that may be sold to a child at less than fair market value (see earlier discussion) may also be gifted to a child without adverse tax consequences. Where properties are gifted, they simply transfer on a rollover basis and the child inherits the farmer's tax position.

All capital assets such as land, buildings, equipment, shares in a family

farm corporation and a partnership interest may be transferred on a rollover basis to a spouse. The spouses can elect to have the rollover rules not apply for any or all these types of properties. Eligible capital properties (e.g. quota) will also transfer on a rollover basis if the farmer ceases to carry on the farming business and transfers it to his spouse. This might happen, for instance, if the farmer is injured and is unable to continue working.

Property that does not transfer on a "rollover" basis between spouses includes the livestock, inventories and accounts receivable of a cash basis farmer which is transferred during his lifetime.

If property is transferred by a farmer to his spouse, attention will have to be given to the effect of the attribution rules. As mentioned above, these rules are discussed in Chapter 5. In summary, any income of an investment nature that the spouse realizes from the transferred property (including taxable capital gains arising from the disposition of the property) will generally be attributed back to the farmer. Business income will not be attributed, however.

## BEQUESTS

### General income tax rules

Transferring assets by means of a will is known as bequeathing. Assets transferred in this manner are treated for income tax purposes as having been disposed of immediately before the individual's death. Because of the extensive rollover rules applying to properties transferred to a spouse and farming properties transferred to a child this "deemed disposition" does not usually result in a substantial tax liability for the farmer's estate.

If the individual's circumstances are such that the rollover rules do not apply, (perhaps because the individual does not have a spouse and his farm assets are rented to a person outside the family), the income tax implications of disposing of his assets on death are as follows:

1. His capital property such as land, shares in a farm corporation, his interest in a farm partnership, his depreciable property written off on the straight-line basis, and his stocks and bonds, etc. are deemed to be disposed of at fair market value and the taxable capital gains or allowable capital losses realized on this disposition will have to be included in the farmer's income.

2. The depreciable property in each class that is written off on the reducing-balance basis is deemed to be disposed of at the mid-point between its fair market value and its undepreciated capital cost. Taxable capital gains, recaptured depreciation or terminal losses arising on this disposition will be included in the farmer's income.

3. The livestock, inventories and accounts receivable of a cash-basis farmer (called "rights and things in the Income Tax Act) are given special treatment. The executors of the deceased farmer have three options.

   (a) All or a part of the value of the rights and things can be included in the farmer's final return together with his other income; or

   (b) The executors can elect within certain time limits to include the rights or things in a separate tax return for the year of death and a second set of personal exemptions can be claimed; or

   (c) If the rights and things are transferred to a beneficiary within certain time limits, the value is included in their income when the rights and things are disposed of.

4. The eligible capital property (e.g. quota) is deemed to be disposed of at two times the balance in the farmer's cumulative eligible capital account. In other words, there is a rollover.

5. There are special rules for resource properties and land that is held as inventory.

Bequests to a spouse or spouse trust

Property bequeathed to a spouse or to a qualifying spouse trust is deemed to pass on a "rollover" basis unless the farmer's executors elect to not have these rollover rules apply. This election is made on an individual property basis and gives the executors considerable flexibility in optimizing the farmer's tax position in the year of death. If, for instance, the farmer has unutilized deductions or losses in the year of death, the executors may wish to elect that certain capital properties be transferred to the spouse at fair market value, so as to generate taxable capital gains that will absorb these deductions or losses.

To qualify for the rollover, the property passing to the spouse, must "vest indefeasibly" in the spouse not later than fifteen months after the date of death and this fact must be established within this period or within such longer period as is reasonable in the circumstances. The term "vested indefeasibly" means that the spouse must obtain a right to absolute ownership which cannot be defeated by a future event. An example of a situation in which a property may not "vest indefeasibly" in a spouse is where shares of a farm corporation pass to her but she is bound by the terms of a shareholder agreement to sell them to the other shareholders. Revenue Canada deals with this and other potential problems in their Interpretation Bulletin IT - 449.

In order for property to pass to a spouse trust on a rollover basis, the

terms of the trust must be such that all income of the trust arising before the spouse's death is received by the spouse. Moreover, no person other than the spouse can obtain the use of any income or capital of the trust during the spouse's lifetime.

This requirement is sometimes not met because of unintended technical problems in the drafting of the will. Remember, that Revenue Canada may discover these problems because a copy of the will is normally requested to be filed with the farmer's final tax return.

An example of a drafting problem in a will is a provision to the effect that in the event of the remarriage of the surviving spouse, the income of the trust shall no longer be payable to her and the trustee may no longer encroach on capital on her behalf. A farmer might consider this to be a reasonable provision to include in his will but would probably change his mind if he was advised that the normal disposition rules would apply to all the assets passing to the trust. There is no problem in stating that the ability to encroach on capital shall cease on remarriage, but there is a problem if the spouse is prevented from receiving the trust's income.

Bequests to children

"Qualifying farm properties" that can be transferred to children on a rollover basis during the farmer's lifetime can also be transferred on a rollover basis on his death. As mentioned previously, these properties are land, depreciable property written off on a reducing-balance basis, eligible capital properties (e.g. quota), shares in a family farm corporation and an interest in a family farm partnership. The land and depreciable property must have been used in a farming business carried on in Canada, immediately before the farmer's death, by the farmer, his spouse or any of his children.

Under current income tax rules, the executors do not have a choice as to the value at which these properties are acquired by the child. With the exception of quota, the properties are simply transferred at their cost amounts (see Glossary). Quota is transferred at 2 times its cost amount.* These transfer values are such that no capital gains or income gains are triggered in the farmer's hands, provided the rollover rules are met.

Property passing on death will not transfer on a rollover basis unless it vests indefeasibly in the child within fifteen months of the date of death and this fact is established within that period or within such longer

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* *The former Liberal government proposed in its budget of February 15, 1984 that with respect to transfers of property after 1983, the personal representatives be permitted to select the values at which certain farm assets are deemed to be disposed of for tax purposes when* *(Continued on next page)*

period as is reasonable in the circumstances. Where there is a will, this vesting provision will not be a problem because the property is treated as having vested immediately after the death of the farmer. However, if there is no will, the vesting requirement could be a problem and may even result in a loss of the rollover.

The rollover may also be lost because of unintended drafting problems in the farmer's will. The type of problems that can be encountered are discussed in Chapter 10 and in Revenue Canada's Interpretation Bulletin IT - 449.

Farmers who are sole proprietors who do not have sufficient liquid assets to satisfy the cash bequests to their children or other members of their family, may want to provide in their wills that before the farm land is distributed to the child who is to carry on the farm, a mortgage shall be placed on the property with the proceeds of the mortgage being paid into the estate. Revenue Canada has stated in its Interpretation Bulletin IT - 349R that provided the arrangement does not constitute a purchase of property by the child, the land and buildings will be treated as having vested indefeasibly in him and the rollover will apply, if the other conditions are met. If, on the other hand, the will provided that the child may receive the land only on the condition that he pay certain amounts to the other beneficiaries, the land will not vest until these payments are made. If the payments are not made until after the fifteen month time limit the rollover will be lost.

Farmers contemplating this sort of arrangement should ensure that they receive expert advice. It may even be appropriate for the professional adviser to seek a ruling from Revenue Canada.

It is to be noted that the "tax cost" of inherited property will not be increased by any portion of the mortgage placed against it by the taxpayer's executors. Furthermore, Revenue Canada has stated that the child will not be able to deduct interest payable on the mortgage. If the mortgage exceeds the tax cost of the property, the child may be concerned. If he had acquired the property from his parents during their lifetime for an amount equal to the mortgage, there would have been an

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*(Continued from previous page)*
*they are transferred to a child of the deceased taxpayer. The value selected for each asset must be between its cost amount (see Glossary) and its fair market value. The property eligible for this rule is all "qualifying farm property" (see Glossary) except quota.*

*This is an interesting proposal that will give the personal representatives additional flexibility in optimizing the deceased's tax position. The farmer should consider whether guidelines should be included in his will regarding the selection of the transfer values.*

increase in the cost base flowing through to him and interest on the debt would have been deductible. The offset, however, is that the farmer would have been subject to tax to the extent that the mortgage exceeded the tax cost of the property and there would have been less assets available for distribution to the children.

Another matter dealt with in Interpretation Bulletin IT - 349R is that where a farmer bequeaths an interest in a family farm partnership to a child, there will not be a rollover for income tax purposes unless the child becomes a partner in the partnership. It is not sufficient for the child to simply inherit a right to receive property from the partnership.

Revenue Canada has issued an Interpretation Bulletin (IT - 446) dealing with legacies in which they state that a taxpayer occasionally bequeaths property to a child on condition that the child provide for the maintenance of the surviving parent during his or her lifetime. The manner in which this arrangement is established will have an effect on the income tax that the child will pay.

If the obligation of the child is an unsecured personal liability, all of the income he receives from the bequested property will be taxed in his return and he will not obtain a deduction for the amounts he pays to his surviving parent. If, on the other hand, the obligation to pay stated amounts to the parent is secured by a charge on the property bequeathed to the child, the income from the property that he reports in his return is reduced by the amounts paid to the parent.

Bequest to children through a spouse trust

A farmer who wants his spouse to enjoy the income from the farm after his death, and to have the property pass to his children on his spouse's death can achieve this by using a spouse trust. Qualifying property will pass into the trust on the death of the farmer and out again on the death of the spouse, and both transfers will be made on a rollover basis. The property that is eligible for this treatment is land, depreciable property written off on a reducing-balance basis, shares in family farm corporations and interests in family farm partnerships.*

LEASES

A farmer who has children who are not involved in the farming business may

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* *The former Liberal government proposed in its budget of February 15, 1984 that for transfers of property after 1983 the trustee be permitted to select the values at which this property is disposed of for tax purposes when it is transferred from the spouse trust to the child. The value selected for each asset must be between its cost amount (see Glossary) and its fair market value.*

bequeath his land to them on the understanding that before the land is distributed from the estate, a lease be entered into with the children who are running the farm. Some commentators have expressed the view that land will not be eligible for a rollover in this situation because the existence of the lease prevents the land from vesting indefeasibly in the non-farming children. Revenue Canada does not appear to consider this to be a problem unless the lease gives the farming children an option to acquire the property. In that situation the land may not vest indefeasibly and the rollover may not apply. This is discussed further in Chapter 10 dealing with estate planning problems.

In order to avoid the possibility of expensive mistakes, farmers who are considering a lease arrangement should receive advice from a professional who is knowledgable in tax matters. This adviser may wish to seek a ruling from Revenue Canada in some situations.

## CHAPTER 5

## TAX PLANNING DURING LIFETIME

### Retirement income planning

The financial security of the farmer during his retirement years will be a major factor in his estate plan. It will have a significant impact on the manner in which he transfers his farming interests to his children because the capital realized from this transfer will often provide him with a substantial portion of his retirement income. The possible ways of dealing with his farm property are discussed in Chapter 4.

In planning his retirement, the farmer will have to consider whether he needs to purchase a new home off the farm. He will also have to think about his activities during retirement and whether by staying on or near the farm he can be useful to his children. Ideally, he will continue to be involved in the family business so that there is a gradual transition from an active farming life to the life of a retired farmer.

In assessing his need for retirement capital the farmer must take into account the effect of inflation. As we have seen in the past few years, a prolonged period of inflation at rates in the range of 8% - 12% can significantly erode an individual's purchasing power. A retired farmer who is debt-free will probably be shielded from the effects of inflation to some extent, particularly if he obtains much of his food from the land. However, even in this situation, inflation must be considered.

In developing his estate plan, the farmer should estimate his annual retirement income from sources such as government pensions, private pensions, and income from the sale or leasing of farm assets. He should compare this income to his estimated expenditures on a year by year basis over the retirement period, ensuring that some adjustment is made for inflation. He should then take this calculation one step further by estimating the extent to which the projected incomes and expenditures will be affected by his death or the death of his wife. There will, for instance, be a substantial impact if the farmer has a significant private pension from a registered retirement savings plan that will no longer be payable after his death. In this second set of projections, the farmer will take into account the effect of any life insurance on the lives of himself or his wife.

These calculations should not be overly difficult for an individual who has been in business for much of his life. He may need assistance from his accountant in estimating his tax liability throughout retirement but, generally, he should be able to do most of the work himself.

The calculations should not be left until the last minute. They will have to be reworked at the time the farmer is planning to retire but they should be done on a preliminary basis much before that time so that the

farmer is able to give an appropriate amount of thought to his options. He should avoid placing himself in the position of having agreed to an overall estate plan with his family and then discovering that it does not provide him with financial security.

In the year in which the farmer retires, he may have an unusually large income for income tax purposes. As will be discussed later, the farmer may be able to achieve significant tax savings on this income by timing his retirement so that he can take advantage of block averaging and forward averaging. To do this he must plan for his retirement in advance.

As mentioned above, the existence of private pensions and government pensions will affect the farmer's estate plans. These and other matters affecting retirement are discussed below.

Income from farm assets

The bulk of the farmer's retirement income will usually be received from his farming property or from the assets he has received in exchange for this property. This income may come in several different forms:

a) dividends on shares in a farm corporation;

b) interest on debt owed by the farmer's children, or by others, in respect of the purchase of the farmer's property;

c) income from the investment of cash received on the sale of assets;

d) rental income from farm property rented to his children or to others; or

e) farm income if he continues to be an income-sharing partner after retirement.

The manner in which a farmer will deal with his farm property will depend on a number of factors such as the number of children, whether some or all of them are interested in farming, the amount of non-farming assets and the farmer's intentions with respect to the distribution of his property. The possible ways of dealing with his farm property are discussed in Chapter 4.

Registered Retirement Savings Plans (RRSP's)

This type of private pension plan is well known to most taxpayers. Farmers and other individuals who have "earned income" are able to contribute up to $5,500 to an RRSP each year. The amount contributed must be paid into the plan during the year or within sixty days after the year-end. An RRSP cannot be assigned as collateral for a bank loan but it can be a very useful tool in saving for retirement and deferring income taxes.

A farmer can contribute up to 20% of his "earned income" to a plan each

year, although the amount contributed cannot exceed $5,500.* The limitation is reduced to $3,500 in certain situations, if the farmer is employed and is a member of his employer's pension plan or deferred profit sharing plan. The term "earned income" includes income from employment, business income, rental income and pension income.

The farmer can contribute to his wife's plan instead of his own or can allocate his contribution between them. This is a useful method of "splitting income" between the farmer and his wife and can result in the saving of income taxes during retirement. It should be remembered that if funds contributed to the wife's RRSP are withdrawn in the year they are contributed, or in the following two years, they are included in the farmer's income rather than the income of his wife. Once this time period has elapsed, funds withdrawn from the wife's plan are included in her income.

The farmer is able to designate a beneficiary in the plan itself and the person named therein should receive the proceeds of the plan after the farmer dies. However, on a strictly technical basis, this designation might not be effective on all types of plans in British Columbia because of a possible flaw in provincial legislation. Because of this, farmers should consider naming their beneficiaries in their wills.

It is important for the farmer to remember that if the beneficiary is a person other than his wife, the amount in the plan at the date of his

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* *The former Liberal government proposed in its budget of February 15, 1984 that the maximum contribution to RRSP's be increased substantially over the years 1985 to 1988. It also proposed that a full-time farmer (as defined), or his spouse, be able to make special contributions to an RRSP of up to $120,000 in order to shelter from tax the gain on the sale of qualifying farming assets that were owned by the farmer or his spouse on December 31, 1983. Qualifying assets include;*

- *real property used in the business of farming at some time between 1972 and 1983 inclusive, by the farmer, his spouse, any of his children or a farm corporation or partnership of the family;*
- *a share of a family farm corporation (see Glossary); and*
- *an interest in a family farm partnership (see Glossary).*

*The maximum combined contribution of a farmer and his spouse is $10,000 multiplied by the number of years between 1972 and 1983 inclusive, in which the farmer or his spouse were full-time farmers. This amount is reduced by the taxpayer's regular RRSP contributions in all years after 1983 up to and including the year in which the farm property is sold.* *(Continued on next page)*

death (including the commuted value of any annuity he might have been receiving from the plan) will be included in his final tax return. His executors may be able to claim some deductions but only in respect of the RRSP funds passing to his children who were dependent on him immediately prior to death.

If, on the other hand, the RRSP funds pass to the farmer's spouse there will be no adverse tax consequences. If the farmer's plan had not matured, the wife will receive a refund of the amount in the plan which she can then contribute to her own RRSP. If the farmer's plan had matured and he had commenced to receive annuity payments, these payments will simply pass to the wife (assuming the plan provided for this) and will be taxable in her hands as she receives them.

The farmer must decide the manner in which he will use his RRSP funds. He can simply withdraw the funds in a lump sum, he can use them to purchase a life annuity or a term annuity to age 90 or he can transfer them to a registered retirement income fund (RRIF) (see below). One of these options must be selected after he reaches the age of 60 and before the end of the year in which he reaches the age of 71. He must choose his product carefully because once it is chosen he cannot change his mind.

If he purchases a life annuity, he should decide whether there should be a joint and last survivor option under which payments will continue until the death of the survivor of him and his wife. If he is in poor health,

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*(Continued from previous page)*
*Under no circumstances can the net special contribution exceed the taxable capital gain realized by the taxpayer on the sale of the qualifying farm assets.*

*The expression "full-time farmer" means an individual who owned a share of the capital stock of a family farm corporation or who leased land for use in the business of farming to his spouse, child, or family farm corporation or to a family farm corporation or partnership of his spouse or child. A full-time farmer also includes any individual who was actively engaged in the business of farming, other than an individual who was or would, if he had losses, be subject to the restricted farm loss rules in Section 31 of the Income Tax Act.*

*An individual over the age limit for making contributions to an RRSP, is nevertheless able to defer tax on up to $120,000 of the taxable capital gains arising from the sale of qualifying farm assets owned on December 31, 1983. To obtain this deferral, he must purchase a qualifying annuity. The cost of the annuity is deductible from income.*

*These proposed amendments are to be effective for the 1984 and subsequent taxation years.*

he may want to consider this option or he may want to consider the purchase of an impaired annuity which takes into account his reduced life expectancy. He will also want to consider whether the annuity should be paid for a guaranteed minimum period and whether there should be an inflation factor built into the monthly payments. Some of these "bells and whistles" will tend to reduce the monthly income in the early years of retirement but in many cases it will be appropriate to have them.

If the farmer is receiving Canada Pension or Old Age Security payments and does not require them to live on, he may transfer them to his RRSP without affecting the amount of his deduction based on his other "earned income". These payments are included in the definition of "earned income" and so 20% can be contributed to a plan for his spouse.

All of the financial institutions offer several different types of plans. Their performance may vary considerably as will the rules dealing with administration fees, the ability to withdraw capital, etc. Some of the plans will invest in common stocks, others will invest in fixed income securities, mortgages or bank deposits. Because there are so many different plans and their relative performance can have a significant impact on the funds that the farmer will have on retirement, he should be prepared to shop around for a plan that suits him. There are a number of booklets on the market that will assist him in doing this.

## Registered Retirement Income Funds (RRIF's)

As mentioned above, a farmer has four retirement options with RRSP's. He can either withdraw the funds in a lump sum, use the funds to purchase a life annuity, a term annuity to age 90 or transfer them to an RRIF.

The life annuity option will generally produce the largest annual cash flow for the farmer during his period of normal life expectancy and is usually the preferred option. However, some individuals are not particularly concerned about the annual cash flow and would sooner defer receipt of income so they can defer tax. Individuals in this situation should consider an RRIF.

Funds invested in an RRIF must be withdrawn on a formula basis over a period ending with the year in which the farmer reaches the age of 90. As an alternative, the payments can be spread over the period ending with the year that his wife reaches the age of 90, provided she is younger than he is. Within limits, the farmer is able to select the rate at which his funds are withdrawn.

An RRIF can be established through several different financial institutions such as credit unions or trust companies whereas a life annuity may only be purchased from a life insurance company.

## Registered Home Ownership Savings Plans (RHOSP's)

The farmer who carries on his business as a sole proprietorship or partnership will generally not be able to contribute to an RHOSP because he or

his wife will own their family home. However, the farmer who has incorporated his farm and has transferred the ownership of his home to the corporation will be able to contribute to an RHOSP provided he and his wife do not own an interest in a property that is being used as a dwelling by any person. He and his wife can each set up a plan and contribute up to $1,000 a year, with a lifetime maximum of $10,000. When the farmer retires he and his wife can withdraw these funds and any accumulated interest thereon tax-free, provided the funds are used within the period set out in the Income Tax Act to purchase a new home.

## Canada Pension Plan

The Canada Penson Plan is an earnings-related contributory plan that provides for a retirement pension and certain supplementary benefits. Contributions based on income are required from the age of 18 to the age of 65 (or 70 if the farmer continues to work and does not apply for his retirement pension). Farmers aged 65 and over can, if they wish, draw their retirement pensions whether or not they continue to work and receive income.

The retirement pension is 25% of the farmer's "average monthly pensionable earnings". The "average monthly pensionable earnings" represents his total pensionable earnings from the start of the Plan, or from age 18, whichever is later, averaged over the period he has contributed to the Plan and expressed on a monthly basis. The maximum retirement pension is earned by making contributions at the maximum level throughout the farmer's working life. To save people from being penalized if they have had periods of sickness, unemployment or low income, there is a provision for the elimination of up to 15% of the contributory period without affecting the calculation of the pension.

The contribution required from a self-employed farmer for a particular year is 3.6% of the difference between his net earnings for that year (not exceeding the maximum pensionable earnings ($20,800 in 1984) and his annual exemption ($2,000 in 1984). If the farmer is employed by a farm corporation, one-half of the contribution is made by him and the other half is made by his corporation.

The present maximum pension under the Canada Pension Plan is $387.50 per month. The supplementary benefits are as follows:

- a pension to the farmer and to his children, if he becomes disabled;
- a pension to his wife, if she is widowed; and
- a death benefit to the farmer's estate.

## Old Age Security

The Old Age Security Pension, known as the old age pension, is a flat rate pension that is payable to any person who meets the age and residency requirements. The amount paid is adjusted each quarter to reflect the increase in the Consumer Price Index. For 1983-84, the indexation is

limited to a maximum of 6 and 5%.

The pension becomes payable when the farmer reaches the age of 65. Farmers who were aged 25 or more on July 1, 1977 and arrived in Canada prior to that date will be eligible for the full pension if they reside in Canada without interruption for the ten years preceding the date they apply for the pension. Farmers who did not reside in Canada prior to July 1, 1977 or were not aged 25 on that date will receive a reduced pension unless they reside in Canada for at least forty years after age 18.

The government has indicated that these rules might be changed in the future to make it easier for retired persons to qualify for a full Old Age Pension.

The old age pension payable on July 1, 1984 is $269.74 per month.

Block averaging

The most widely-used method of income averaging available to farmers is the five-year block average. The use of this form of averaging can result in substantial tax savings throughout the farmer's business life and, in particular, in the year in which he retires. As its name suggests, block averaging can only be used at intervals so its use should be well-planned.

The mechanics of the averaging calculation are complicated but are explained in detail in Revenue Canada'a Taxation Guide for Farmers and Fishermen. The effect of the calculation is that all income received in the period of averaging (generally five years) is treated as though it had been received in equal annual amounts over the averaging period. This can give rise to tax savings as a result of the following:

- the deduction of personal exemptions or losses that were not deducted in previous years in the averaging period because the farmer did not have sufficient income in those years; and

- the application of lower tax rates than would otherwise have applied in the "higher income" years.

In the year in which a farmer retires he may have a substantial income for tax purposes. If he does, it will probably be advantageous to arrange the timing of his block averaging election so that he can make an election in the year of retirement. Obviously, this requires some advance planning.

Forward averaging

Forward averaging is a new form of averaging introduced into the Income Tax Act in 1982 that is available to all individuals. Unfortunately, it is not as beneficial as the "averaging" that used to be available through the purchase of income-averaging annuities.

The benefit that can be derived from forward averaging is the ability to have income spread over a number of years and taxed at marginal rates that

are lower than the rate that would have applied had the income been fully taxed in one year. There may be a cost, however, in that the income that is to be "forward-averaged" is initially taxed at the top rate and this rate may be higher than the rate that would otherwise have applied. The farmer is therefore required to compare the tax saving that may ultimately be obtained through a reduction in the tax rate, with the tax cost of prepaying income taxes.

When a farmer retires, forward averaging can be combined with block averaging to achieve significant tax savings. Ideally, the farmer should arrange his affairs so that he can block average in the year in which he retires, or in the previous year if that is appropriate, and then forward-average after his retirement.

More information on forward-averaging can be found in "Taxation and the B.C. Farmer", published by the Ministry of Agriculture and Food in British Columbia.

Tax deductions and exemptions during retirement

A retired farmer and his wife can reduce their income tax liability by claiming certain deductions and exemptions available to them.

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|---|---|
| Pension income deduction: | Individuals can deduct up to $1,000 of their qualifying pension income. An annuity from an RRSP or payments from an RRIF will qualify if they are aged 65 or older. Canada Pension and Old Age Security payments do not qualify. |
| Age exemption: | This exemption, which is indexed to inflation, can be claimed by each person aged 65 or older. The amount deductible in 1984 is $2,480. |
| Interest, dividends and capital gains deduction: | This deduction of up to $1,000 may be claimed in respect of interest from Canadian sources, dividends from certain taxable Canadian corporations and capital gains on the sale of Canadian securities. Income received from relatives and dividends received from a controlled corporation are not eligible. |

If one spouse is not able to fully utilize the above deductions, the unused portion may be deducted by the other spouse.

Other planning

Income splitting

The reduction of income taxes is an important objective of estate planning

and this can usually be achieved by income splitting within the family.

Great care must be taken in the method in which it is carried out, however, because the Income Tax Act contains a number of provisions which are designed to prevent the transfer of income from one member of the family to another.

Perhaps the most powerful weapon at Revenue Canada's disposal is the attribution rules. These rules provide that where property has been transferred by a taxpayer to his spouse or to a person who subsequently becomes his spouse, any income or taxable capital gains realized from the transferred property or from property substituted therefore, will be attributed to the transferor for purposes of the Income Tax Act. The income or taxable capital gains may legally belong to the recipient of the transferred property (the transferee) - but will be taxed in the hands of the spouse who originally owned the property (the transferor). This rule applies only while both spouses are alive, they remain married and are residents of Canada.

A similar rule applies to transfers made to minors. Where the taxpayer has transferred property to a minor, the income earned thereon in years before the year in which the minor reaches the age of 18 will be taxed in the hands of the taxpayer. Any taxable capital gains realized from the disposition of the transferred property will generally not be attributed back to the transferor.

The tax courts have decided that the attribution rules may be avoided if an individual makes a valid loan to his spouse or child instead of transferring money or property directly. The loan must be a legitimate transaction, however. To evidence the arrangement there should be a note payable on demand signed by the spouse receiving the funds. The loan should be interest-free in order to achieve the desired result of reducing the taxpayer's income and increasing the income of his spouse. The loan should be repaid on a regular basis to ensure that the note does not become "statute barred". "Statute barred" means that the holder of the note cannot take the usual legal steps to enforce collection. If this happens, the uncollected amount may be treated as a gift that is subject to the attribution rules. The terms of repayment specified in the note should be strictly adhered to.

The borrower should deposit the loan proceeds in a separate bank account and should purchase the investment out of that account. The use of a joint bank account for a transfer from one spouse to another may not be effective.

Loan arrangements will also work with children but obviously, there will be additional concerns about the use of the transferred funds. It will probably be advisable to use a trust so that control of the funds will rest with someone other than the child.

It is to be noted that the spousal income attribution rules apply only in respect of income received from transferred property, they do not apply to

business income. Accordingly, if a farmer transfers land and buildings to his spouse and she uses them in carrying on a farming business, the farm profits will not be attributed back to the farmer.

## Tax shelters off the farm

The term "tax shelter" is applied to a wide variety of tax deferral plans that permit an investor to deduct a substantial part of his investment from income currently, or allow him to shelter income from tax indefinitely. In some cases, the plans permit the investor to pay for his investment over a number of years and to finance his contributions through tax savings.

The types of tax shelters now available are:

- limited partnership investments in hotels and other businesses;
- research and development investments;
- real estate investments; and
- oil and gas properties.

Investing in tax shelters is not usually of interest to many farmers because they obtain a sufficient shelter through being able to use the cash basis of reporting in their farm business.

Farmers who have businesses with low debt loads and could use additional tax deductions will often not consider the typical tax shelter because they are not able to evaluate their investment merits. They would prefer to put their savings in a solid investment that is more closely related to their business.

A detailed discussion of tax shelters is beyond the scope of this publication. Suffice to say that there are many different types available, each entitling the investor to a tax credit or to a deduction for all or a part of his investment. These tax benefits must always be put in the proper perspective. They will enable the investor to recover a portion of his investment and reduce the amount that he has "at risk" if the investment fails, but the over-riding factor must be the underlying merits of the investment. There is a popular saying that there is no point in throwing away a dollar to achieve a tax saving of 50 cents! This is what people do when they invest in tax shelters which do not have investment merits!!

## CHAPTER 6

## USE OF CORPORATIONS IN ESTATE PLANNING

### Introduction

Many farmers consider a corporation to be a cumbersome and expensive vehicle in which to carry on a farming business. They share this opinion because the incorporated farmer is required to prepare an additional tax return and more extensive accounting information; he must become familiar with an additional set of tax rules; he will lose his ability to block average, he will probably have to pay a significant legal and accounting bill to transfer his assets to a corporation, and finally, he will have to contend with additional legal formalities.

All of this is true, yet the corporation has its place in estate planning. It can be useful to the farmer who has a successful, mature business and is looking for ways in which he can defer income taxes. It can also be useful to the farmer who has several non-farming children and relatively few non-farming assets and is trying to develop an equitable estate plan.

A complete discussion of the use of corporations is beyond the scope of this publication. Additional information can be obtained from the booklet called, "Farm Business Corporations in British Columbia", published by the B.C. Ministry of Agriculture and Food.

### Income Tax Deferral

As explained in Chapter 3, a Canadian-controlled private corporation carrying on a farming business in Canada pays tax at the rate of 23% on the first $200,000 of taxable farm profits each year. Under the current rules, this low rate continues until the corporation has earned $1,000,000 of profits. Thereafter, the normal corporate rate of approximately 52% applies.*

If the farm corporation is associated (as defined in the Income Tax Act) with other corporations, the $200,000 and $1,000,000 limits are shared among them.*

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* *The former Liberal government proposed in its budget of February 15, 1984 that this $1,000,000 limitation be eliminated. This change is to be effective for taxation years ending in the calendar year following the calendar year in which the proposal is enacted into law.*

A corporation eligible for the low rate of tax is liable to a second tax (referred to as the "distribution tax") when it distributes its after-tax profits to its shareholders. This "distribution tax", calculated as 12 1/2% of the taxable dividends paid, applies only to dividends paid out of profits taxed at the low rate and accumulated in years commencing after 1982.

The "distribution tax" is intended to remove the benefit that businessmen have received in the past by incorporating their businesses. However, because it is not payable until the corporation's after-tax profits are distributed to the shareholders, a tax deferral can still be obtained. This is illustrated in Appendix 3 on page 76.

Dealing with non-farming children

As discussed in Chapter 10, one of the most common estate planning problems for the farmer is to develop a plan that treats his non-farming children equitably (not necessarily equally) and allows his farming children to continue operating the business. Sometimes these objectives cannot be reconciled and the farmer, his executors or his children are obliged to sell a substantial portion of the farm to persons outside the family. In some situations, however, the use of a corporation provides the answer to the farmer's problem. The outline of one arrangement that might work in some situations is illustrated hypothetically in Appendix 4 on page 78.

Other matters to consider

(a) Principal residence

A farmer will want to consider whether he should keep his principal residence outside of the corporation. If he continues to own it personally he will retain the ability to claim the principal residence exemption on the home and up to 1/2 hectare of land and will continue to be eligible for the home-owner's grant.

If the home is on a small acreage with a separate legal title, it will probably be advantageous to leave it outside of the corporation. If, however, it is situated on a large acreage together with farm buildings and cannot be subdivided, this may not be appropriate. The farmer would then be required to rent the property to the company or to make some other arrangement that would allow the company to make use of it.* If the

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* *The former Liberal government proposed in its February 15, 1984 budget that property leased by an individual to his family farm corporation (see Glossary) or to a family farm corporation or partnership (see Glossary) of his spouse or child be treated as property used in the business of farming for purposes of these rollover rules. This change is to be effective for property transferred after December 31, 1983.*

property is simply rented then, under the current tax rules, it will generally not be treated as being used in the business of farming and will not be eligible for "rollover" to the farmer's children. There may be other tax problems as well. This is discussed further in Chapter 10.

Some farmers have attempted to deal with this problem by transferring to the company only a partial interest in the property. The undivided interest that they retain is equal to the proportion of (a) the value of the home plus 1/2 hectare to (b) the value of the whole property. Revenue Canada has indicated that it does not consider this arrangement to be valid in a strictly legal sense. However, if the farmer's solicitor is prepared to use it and the farmer recognizes that it may complicate his financing arrangements at some point in the future, he may not have much to lose by trying it.

(b) Potential Double Tax

When a taxpayer transfers property to a corporation on which there is an accrued gain to the date of transfer, and an election is filed so that the transaction is completed on a "rollover basis", there is a possibility that the accrued gain will be subject to a double tax. It will be taxed in the corporation when the corporation disposes of the property and it will be taxed a second time when the taxpayer or his heirs dispose of the shares that were issued by the corporation in exchange for the property.

As a practical matter, this is not usually viewed as a significant problem for the farmer because the shares of a family farm corporation (as defined in the Income Tax Act) can be transferred from one generation to the next on a rollover basis. If the farm is to be sold in the near future or a significant portion of the shares issued by the corporation for the transferred property are to be redeemed in that period, the farmer's adviser should give more attention to this matter. In the latter situation, there is not likely to be a serious problem if the redemption is to be financed out of profits earned after the formation of the company.

(c) Sales Tax

Provincial sales tax should not be a significant concern because the majority of the farmer's assets will be exempt from tax. However, the tax could still apply to automotive equipment and certain other assets unless the farm is transferred to a new corporation, immediately after its incorporation. Generally, it will be necessary for the farmer, his spouse (or the family partnership, if it is transferring assets to the corporation) to own all the shares in the corporation (regulations 3-14 and 3-15 of the Social Service Tax Act).

(d) Need for professional advice

It is extremely important for the farmer to receive advice from a lawyer and a qualified accountant before incorporating his farm and setting up his estate plan. One or both of these individuals should be thoroughly

experienced in tax matters. This advice should be obtained well in advance of the transaction.

The transaction will have to be structured carefully so that it fits within the rules in the Income Tax Act dealing with "rollovers" to corporations. A special income tax election will have to be filed with Revenue Canada within prescribed time limits.

The farmer's adviser may feel it is necessary to obtain an advance income tax ruling from Revenue Canada to avoid the possibility of there being any adverse tax consequences. He is more likely to consider this possibility if conditions are to be attached to certain classes of shares issued by the corporation that will restrict the right of the holders to redeem them in certain situations. At a minimum, the adviser will want to determine what Revenue Canada's current assessing policy is - because it changes from time to time.

The need for care cannot be over-emphasized. If the transaction is structured incorrectly, the farmer could be exposed to a massive tax penalty.

# CHAPTER 7

## LIFE INSURANCE

### Introduction

Life insurance can play a useful role in the estate plan of a farmer provided his insurance needs are correctly identified and the product sold to him meets those needs. Unfortunately, this is easier said than done because there are many different insurance products available and some are considerably more competitive than others.

In assessing his insurance needs, the farmer will have to rely quite heavily on the advice he receives from his professional advisors such as his accountant, lawyer, government agricultural representatives and, most important, his life insurance agent. Insurance agents can be divided into two classifications; those who act as brokers and represent several insurance companies and those who represent only one company.

Basically, there are two types of insurance available - term insurance and permanent insurance. Term insurance is usually cheaper because it pays only in the event of the death of the insured person and there is no savings element. The policy is renewable every year or every five years and the premium is usually adjusted at each renewal date in accordance with a schedule that is known when the policy is entered into. As the individual gets older, the premiums increase. In the latter years of his life, term insurance becomes very expensive.

If the policy has a guaranteed renewal clause, it may be renewed without a medical examination. If it has a conversion clause, it may be converted into permanent insurance even though the individual may become uninsurable.

The most important aspect of term insurance is that it is not permanent. It has to be renewed and it will only be of benefit if the policy is in force when the insured dies. If the individual's health deteriorates and he becomes uninsurable without having a guaranteed renewal clause, his policy will terminate. In the past, term insurance policies were not normally available beyond the age of 65. Now, there are a number of new products on the market that are available beyond that age.

It is possible to buy certain types of term insurance through a group plan. The most common example is the mortgage insurance that is often available through banks, credit unions or other financial institutions. Group insurance may also be available through certain farm producer groups.

Permanent insurance continues its coverage through to the death of the person insured; it cannot be cancelled by the insurance company except through the non-payment of premiums and it does not stop when the insured

reaches the age of 65 or 70. This type of insurance can be looked upon as "term for life". The premium for this type of policy will be higher than term insurance because the insurance company knows it will have to pay the sum insured.

A portion of the insurance premiums paid under a permanent insurance policy is credited to a "reserve" by the insurer. Over the life of the policy, this reserve (or cash value) will increase to the amount insured under the policy. If the policy is cancelled or surrendered before maturity, the owner is entitled to the accumulated cash value of the policy. In addition, the owner can usually borrow against the reserve provided he is prepared to pay interest to the insurer. When the owner dies, the amount paid out under the policy will be reduced by any outstanding loans.

Participating insurance policies allow the owner to participate in the investment performance of the life insurance company. Naturally, the premiums are higher. His participation is received in the form of dividends that can be received in cash, or applied to current premiums or used to purchase additional insurance.

Insurance companies have recently developed policies that pay-out only on the death of the survivor of the husband and wife. This is a useful product because very often a family will not need liquid funds to pay income taxes or to finance bequests to children until both parents are dead. Depending on the circumstances, this type of policy can be considerably cheaper than a conventional one that is payable on the death of one of the parents.

## Use of Insurance

Life insurance has several possible uses in a farmer's estate plan. It may be purchased for one or more of the following reasons:

1. To provide coverage on farm bank loans.

2. To fund a buy-sell agreement between unrelated partners in a partnership or shareholders of a corporation. This funding may also be desirable in situations where brothers and sisters carry on a farming business together.

3. To provide cash to the estate of the survivor of the farmer and his spouse which can be used to fund bequests to non-farming children.

4. To provide income to the surviving spouse through the investment of the insurance proceeds.

5. To provide liquid funds to the estate to enable it to pay income taxes (if any) and estate clearance costs such as solicitors fees.

## Tax Implications

The tax treatment of insurers and their products has undergone much change over recent years. A detailed discussion of the current rules is beyond the scope of this publication because they are too complicated.

There will be no tax payable by an estate in respect of the proceeds from a term insurance policy. There will also be no tax in respect of the pay-out of an "exempt" permanent policy, provided the pay-out occurs as a result of the death of the owner. Essentially an "exempt" policy is one that is bought for protection purposes rather than as an investment. Generally, all policies acquired before December 2, 1982 will be considered to be "exempt" unless they are changed after that date. Most policies acquired after December 1, 1982 will be "exempt" too.

The pay-out under a "non-exempt" permanent policy may give rise to tax as will a payment under any permanent insurance policy that is cashed in by the owner during his lifetime. The amount that is included in income is the excess of the amount received under the policy over the adjusted cost base of the policy.

Individuals who acquire non-exempt policies will be taxed annually (or every three years) on the investment income that accrues within the policy even though this income might not be received by them until the policy pays out.

Policy loans are treated for income tax purposes as being proceeds of disposition of the insurance policy and an amount will be included in income to the extent that the loan exceeds the adjusted cost base of the policy.

Generally, premiums paid on life insurance policies are not deductible for income tax purposes. However, taxpayers who are required to purchase term insurance as collateral for their business loans are able to deduct the insurance premiums in most situations. The requirements that must be met are set out in Revenue Canada's Interpretation Bulletin IT-309R.

## Conclusions

Because of the complexity of the subject and the multitude of products on the market, the farmer will need the advice of an insurance agent. Ideally, the agent will be able to compare the products of several different insurers so that the farmer gets the "best deal". The farmer must satisfy himself that he needs the product being offered to him and the agent has recommended the best plan.

## CHAPTER 8

## IMPLICATIONS OF FAMILY LAW REFORM

### Introduction

Approximately four out of every ten marriages end up in the divorce courts these days so it is important that the farmer have some understanding of the provisions of the B.C. Family Relations Act. This Act sets out the manner in which a family's assets are divided between a husband and wife in the event of a marriage breakdown. Because it can have a significant effect on an estate plan the farmer should ask his solicitor for advice when he prepares or updates his will.

The basic premise of the Act is that marriage is an economic partnership through which each spouse is entitled to share in the financial rewards of the other's efforts. The Act establishes a category of assets called "family assets" that must be divided between the spouses in the event of a marriage breakdown.

The classes of assets that are defined as being "family assets" are as follows:

(a) any property owned by a spouse and ordinarily used for family purposes; and

(b) assets owned by a spouse and used for business purposes, if the spouse who does not have an interest in the property has made a contribution in money or money's-worth to the acquisition of the asset.

Category (b) above is extremely broad because a contribution towards the purchase of the property is deemed to include any savings realized by the family through a spouse's effective household management or child - rearing responsibilities. In many cases, it will be difficult to argue that a spouse has not made at least some contribution in this sense to all the assets acquired during marriage. This will be particularly true on a family farm where the wife not only maintains the home but usually helps with farm chores as well. As a result, virtually any type of asset can constitute a family asset for purposes of the Family Relations Act.

Based on recent court decisions, it appears that a spouse can acquire the right to share in a particular property even though it might have been owned by the other spouse before marriage or might have been obtained by that spouse from his or her parents. This is particularly true where the marriage is of reasonably long duration - say ten years.

The right of a spouse to receive a share of the "family assets" arises when there is a "marriage breakdown". This term is defined in the Family Law Reform Act as including the following:

1. The making of a separation agreement;

2. The issue of a judgement of the Supreme Court that the spouses have no reasonable prospect of reconciliation;

3. The making of an order for dissolution of the marriage or judicial separation; or

4. the making of an order declaring the marriage null and void.

Tax implications of the division of family assets

As mentioned in Chapter 4, the Income Tax Act contains provisions that enable certain property to be transferred between spouses on a rollover basis unless the transferor spouse elects to not have the rollover rules apply. These provisions also apply where there is a division of property pursuant to a provincial statute such as the Family Relations Act. Despite the existence of these rules, however, the division of family assets can result in income tax problems. The problems arise because either the particular asset is not covered by the spousal rollover rules or the court directs that the asset be transferred to a person other than a spouse.

Looking at the position of a farmer, income tax problems can arise in the following situations:

1. Where quota is transferred to the farmer's spouse it will usually be treated as having been sold at fair market value. One-half of the proceeds will generally be included in the farmer's income. If, as part of the settlement, the farmer ceases to carry on farming and his spouse commences to carry on the business, there will be a rollover for income tax purposes.

2. Livestock and other inventories transferred to the farmer's spouse (or his children) will also generally be treated as having been sold at fair market value.

3. Land and buildings transferred to a trust for the benefit of the farmer's wife will not transfer on a rollover basis unless the provisions of the trust meet the requirements of the Income Tax Act. If the trust is imposed by a court order, there is some question as to whether the rollover will apply in any event because the trust may not be regarded as having been created by the farmer. This is required under the Income Tax Act.

Attribution Rules

As a general rule, where property is transferred between spouses, income and capital gains earned thereon are attributed to the transferor spouse. Similar rules apply where property is transferred to a child under age 18

except that generally, they do not apply to capital gains realized on the disposition of the transferred property. These provisions are discussed in more detail in Chapter 5.

Where property is transferred to a former spouse the attribution rules do not apply. Where the transfer is made to a spouse who is living apart and is separated pursuant to a decree, order or judgement of a competent tribunal or a written separation agreement, the rules are as follows:

| | | |
|---|---|---|
| a) | Income from the transferred property | - Income ceases to be attributable after the written separation agreement or after a judgement or order. |
| b) | Taxable capital gains from the sale of the transferred property | - Taxable capital gains cease to be attributed if after the separation or judgement the parties elect jointly that the attribution rules shall not apply. |

It is to be noted that where there is a separation, the exemption from the attribution rules applies only where the separation does not cease within twelve months from the date on which the separation agreement was entered into.

Planning

In some cases, a straight-forward division of the family assets of a farmer will result in a significant tax liability and it will be in the interests of both parties to see if they can restructure the distribution so that the tax is deferred.

A person who is contemplating marriage, perhaps for the second time, may want to review with his or her solicitor the extent to which the provisions of the Family Relations Act can be avoided or limited by entering into a marriage agreement. Discussing this sort of agreement with a "bride or bride groom-to-be" may not be easy because it is tantamount to saying that I love you but ..... However, these agreements are being used more often these days.

Where property is being transferred by parents to their son or daughter and there is some concern over the Family Relations Act, the parties may want to make it abundantly clear in the documents that the transfer is being made to their child and not to his or her spouse. This may have the effect of reducing the spouse's claim on the property being transferred if there is a marriage breakdown at some future time. This may not be particularly difficult if the child's spouse is not a party to the arrangement. If, however, the family attempts to take this one step further and request that the spouse become a party to the arrangement it would be necessary for the spouse to obtain independent legal advice and a major family problem might arise.

## CHAPTER 9

## ADMINISTRATION OF THE ESTATE

### Introduction

The administration of an estate involves the collection, management, and realization of the property of a deceased person and the distribution of that property to the beneficiaries of the estate. It will be carried out by the deceased's executor (or administrator if there is an intestacy) with the help of a solicitor.

As discussed in Chapter 2, the farmer's executors will normally include his spouse and one or more of his children. If they are not able to fully understand his business affairs the family's accountant or solicitor might be involved as well.

The administration of a farmer's estate may take up to six months, or even longer, because there will be a substantial number of assets to locate, value and transfer to the intended beneficiaries. The job will be somewhat easier if the farm is incorporated because the distribution of the farm property will be accomplished by simply recording the transfer of the shares in the company's share records.

The farmer should look upon the administration of his estate as the final test of his estate plan. He will not be around to see if his plan passes this test but his family and friends will. If his planning is effective, his executors' job will be made considerably easier.

The steps the farmer can take to help his executor are as follows:

1. Ensure that all members of his immediate family are aware of, and in agreement with, the provisions in his will and know where the will is kept.

2. Ensure that his will takes into account all changes in his business and family situation, it is expressed clearly, and provides for the disposition of his assets in an orderly and reasonable manner.

3. Ensure that the executor is aware that he has been named and that there are alternates in the event that he is unable or unwilling to act.

4. Maintain a listing of major assets and liabilities and ensure that his spouse and children know where it is kept. This listing should include the street address or legal description of real property owned, a description of the major farm equipment and its location, bank account numbers and details on insurance policies, etc. Attached to this

publication is a blank checklist that may be cut out and used for this purpose.

5. Keep valuable papers such as land title documents, mortgages, agreements for sale, share certificates, bonds, savings account pass books and insurance policies in a safe place and ensure that his spouse and children know where they are.

## Role of the personal representative

The executor (or the administrator if there is an intestacy) has significant responsibilities placed upon him. He will usually delegate much of the work to a solicitor or accountant, but ultimate responsibility remains with him.

His initial responsibility will be to make appropriate funeral arrangements and to request a solicitor to apply to the court for Letters Probate. This document confirms the validity of the will and the executor's appointment. If there is no will, an administrator would apply for Letters of Administration. If the executor appointed in the will is unwilling to act and there are no alternates, an administrator would again apply for Letters of Administration with Will Annexed.

An administrator may be required to post a bond with the court. This requirement can be dispensed with where all parties interested in the estate consent to it in writing.

In obtaining Letters Probate (or Letters of Administration) the personal representative will determine the nature and value of the assets and liabilities of the deceased. After, he will advertise for information on debts that he is not aware of, calculate and pay the income tax liability of the deceased and the estate, obtain a clearance certificate from Revenue Canada evidencing that all income taxes have been accounted for, obtain the consent of the beneficiaries or pass the accounts through court, convert the assets to cash and distribute the proceeds or, if empowered to do so, distribute them "in specie" (see Glossary), set aside the assets or funds which are to be retained, pay all legal fees and other costs of settling the estate and, finally, account to the beneficiaries, and to the court if required to do so, for all actions in connection with the administration of the estate.

Under the Trustee Act, the personal representative is allowed to receive up to 5% of the gross value of the assets of the estate as compensation for the services he performs.

## Role of the solicitor

The solicitor's function is to act on behalf of the executor or administrator. He will normally advise the personal representative on legal matters affecting the administration of the estate, prepare the application for Letters Probate or Letters of Administration, prepare the

documents required in connection with the conversion of assets to cash or the distribution of property to beneficiaries, and assist in the preparation of the financial accounts of the personal representative.

Property that does not become part of the estate

Certain property passes directly to the deceased's beneficiaries, rather than through his will, and does not, therefore, become part of his estate. The distinction is significant because property treated in this manner cannot be seized by the deceased's creditors.

Assets that do not become part of the deceased's estate include the following:

- property held in a joint tenancy arrangement (see Chapter 3);
- proceeds from life insurance policies which have named beneficiaries; and
- proceeds from a registered retirement savings plan which has a named beneficiary.

Tax liability of the deceased

As discussed in Chapter 4, a deceased person is deemed to have disposed of most of his assets immediately before his death and the resulting taxable capital gains, allowable capital losses, recaptured depreciation, etc. are included in his final tax return. Because of the extensive rollovers available to farmers in respect of property bequeathed to a spouse, a spouse trust or a child, this deemed disposition will not usually result in a significant tax liability.

The livestock, feed inventories and accounts receivable of a cash basis farmer that are bequeathed to a beneficiary are given special treatment under the Income Tax Act. These properties, together with certain other assets such as uncashed bond coupons, (described in the Income Tax Act as "rights or things") may be included in the deceased's final return or in a separate return on which a second set of personal exemptions is claimed. If the rights or things are distributed to the beneficiaries within one year of death or within 90 days after the mailing of the Notice of Assessment for the year of death, whichever is later, the value of the rights or things are included in the beneficiaries' income in the year in which they dispose of the properties. These rules, in effect, provide a rollover for livestock, inventories and accounts receivable bequeathed by a farmer.

To the extent possible, the personal representatives will want to fix the deceased farmer's income in the year of death so as to utilize his unabsorbed losses, charitable donations and tax credits, and to keep his income taxes to a minimum. They will need to take into account the amount of the livestock adjustment added to the farmer's income in the year preceding the year of death. This amount will be deductible in the final

return together with any unused basic herd deduction.*

If a farmer who was a sole proprietor or a partner in a farming business, dies after the fiscal period of the business but before the end of the calendar year in which the fiscal period ends, the personal representative may file a separate return in respect of the business income for the period commencing with the end of the fiscal period to the date of death.

If the farmer had sold farm property during his lifetime and had been carrying forward a capital gain reserve in respect of the unpaid sale proceeds, one-half of the reserve must be included in the farmer's final return as a taxable capital gain. Similarly, if the farmer had been carrying forward an income gain reserve (e.g. arising from the sale of cattle by an "accrual basis" farmer), the reserve must be included in his final return as income. If these debts receivable on which the reserves were being claimed are bequeathed by the farmer to his spouse, the reserves flow through to her provided a special election is filed with Revenue Canada.

If the farmer realizes allowable capital losses in the year of death, or in the preceding year, they can be deducted from income from any source, without restriction. Ordinarily, these losses may only be deducted from taxable capital gains and up to $2,000 of other income.

Gifts made to registered charities in the year of death, or bequeathed to them in the farmer's will, are deductible in the farmer's final return or in the return for the previous year. The amounts deductible cannot exceed 20% of the farmer's income in those years.

Filing of returns and payment of tax

The tax return for a year ending prior to the farmer's death must be filed within six months of the date of death. The return for the year of death (the final return) must generally be filed by the later of six months following the date of death or April 30 of the taxation year following the date of death. To illustrate, if a farmer died on January 31, 1984 and had not filed his 1983 return before death, his personal representatives would have to file his 1983 return by July 31, 1984 and his 1984 return by April 30, 1985.

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* *It is to be noted that the former Liberal government proposed in its budget of February 15, 1984 that with respect to transfers of property after 1983, the personal representatives be permitted to select the values at which certain farm assests are deemed to be disposed of for tax purposes when they are transferred to a child of the taxpayer. The value selected for each asset must be between its cost amount (see Glossary) and its fair market value. The property eligible for this rule is all "qualifying farm property" (see Glossary) except quota.*

Where a spouse trust is created under the deceased's will, the final return may be filed up to eighteen months after the date of death. If there is a separate return for rights or things, it must be filed by the later of one year from the date of death and the date that is ninety days after the mailing of the Notice of Assessment in respect of the final return.

The estate itself must also file a return. If the administration is completed in less than a year there will be only one return covering the period of administration. If it extends beyond one year, a separate return will have to be filed for each "taxation year". The "taxation year" of an estate is the period for which the accounts are ordinarily made up. Usually, the taxation year of the estate will end on the anniversary of the date of death or on December 31. The taxation year cannot exceed twelve months and after the year-end has been established it cannot be changed except with the permission of Revenue Canada.

Ordinarily, the tax owing by the deceased is due on or before the date that the return has to be filed. However, to the extent that the deceased has amounts included in his income in respect of rights or things or in respect of taxable capital gains or recaptured depreciation arising from the deemed disposition of capital property owned at death, the personal representative can elect to pay the tax in up to ten annual instalments. The government charges interest on the unpaid tax.

## Clearance certificate

It is important that the personal representative obtain a clearance certificate from Revenue Canada before distributing the deceased's estate to the beneficiaries. If he fails to do this he will become personally liable for the unpaid taxes, interest and penalties. There are separate clearance certificates for the taxation years of the deceased and the estate. The procedures to be followed are discussed in Revenue Canada's Interpretation Bulletin IT - 282R and Information Circular 82 - 6.

## Accounting records

Except where the personal representative is the sole beneficiary, the personal representative must keep accurate accounts summarizing his administration of the estate. The accounts will generally include an inventory of the original estate assets, details of all money received and disbursed and a summary of the assets on hand. The supporting books and records should be maintained until all clearance certificates have been issued.

## CHAPTER 10

## COMMON ESTATE PLANNING PROBLEMS AND THEIR SOLUTIONS

### Providing for the non-farming children

One of the most common estate planning problems of the farmer today is how does he provide for his non-farming children? The problem is particularly acute for the farmer who has relatively few "off-farm" investments and would like to transfer his farm intact to the children who are involved in the business.

The farmer's problem has been made worse by the dramatic increase in the level of investment in the average farm in the last ten years. These higher farm values have obliged farmers to increase their bequests to their non-farming children, and because these bequests are funded by the income from their businesses, the future financial viability of the farms is sometimes placed in jeopardy.

Information released recently by one of the chartered banks in Canada illustrates the magnitude of the problem. In 1971, the average capital per farm was $66,000 whereas in 1981 it was $410,000. This represents a 621% increase over 10 years. If the cash flow from the average farm had increased at the same rate, the problem would not be as significant. But, unfortunately, it has not.

A development which compounded the problem was the introduction of tax on capital gains in 1971. Because of the substantial increase in asset values that have occurred in the past decade, many family farms now have significant accrued capital gains.*

In approaching the problem, the farmer must first consider the manner in which his children will share in his assets. It will not necessarily be an equal share, but it should be an equitable one. Whatever arrangement

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* *It is to be noted that the former Liberal government proposed in its budget of February 15, 1984 that a full-time farmer be able to shelter from tax up to $120,000 of the taxable capital gains arising from the sale of certain farm assets owned on December 31, 1983 by making a special contribution to his RRSP. This proposal is described on page 35 of Chapter 5.*

is decided upon must provide the farmer with the retirement capital he needs.

Some farmers have achieved their objectives by the purchase of insurance. The manner in which this might be done can best be illustrated by a hypothetical example.

Assume the following:

(1) A farmer and his wife carry on business in partnership.

(2) The total adjusted cost base and fair market value of their interests in the partnership are $300,000 and $1,000,000 respectively.

(3) They have a term insurance policy for $400,000.

(4) They have two sons, who will carry on the farm, and two daughters who are not involved on the farm.

(5) They need $300,000 of retirement capital.

In this situation, the parents might proceed as follows:

(1) They might transfer their partnership interests to their sons during their lifetime for $300,000 cash. There would not be any tax on the gift to the sons nor would there be any income taxes payable, assuming the partnership is a "family farm partnership" (see Glossary); and

(2) They might provide in their wills that after the death of the survivor of them, the residue of their estates shall be divided among all of their children in a manner that will recognize the earlier gift to their sons. As the sons will have inherited their parents' tax liabilities and may have contributed value to the farm, the gift may be looked upon as being something less than $700,000 - perhaps $400,000. On this basis, the first $400,000 of the residue of the estate (the insurance proceeds) would be distributed to the daughters and the balance would be distributed equally to all of the children.

To evaluate this option, it is necessary to take into account the cost of insurance. Unfortunately this is difficult to do because there are a great many insurance products available and the premiums thereon are affected by the insured's personal circumstances. However, in order to provide the reader with a very general idea of what the cost might be on a $400,000 policy, certain information provided by an insurance broker from a review of the term insurance products now offered by the major insurers is summarized below. The figures quoted are based on the assumption that the insured person is a male, is in good health and is a non-smoker.

| Age At Which Policy Taken Out | Estimated Annual Premiums: Regular Term Insurance (Note 1) | Estimated Annual Premiums: Level Term Insurance to Age 100 (Note 2) |
|---|---|---|
| 40 | $ 750 | $ 1,950 |
| 50 | $ 1,700 | $ 4,050 |
| 60 | $ 4,000 | $ 7,400 |

1. The regular term insurance is normally available only to the age of 65 or 70. The premiums noted are those applying in the initial five year period only. Premiums in subsequent renewal periods are higher.

2. The premiums noted for the Level Term Insurance to age 100 apply only for the first five years. In the subsequent periods there may be an increase or reduction depending on the future direction of interest rates.

   The premiums for this type of policy are considerably higher than ordinary term insurance in the initial years because there is permanent protection. In other words, assuming that premiums are paid until death, it is virtually certain that the insured's family will receive the insurance proceeds. With ordinary term insurance the insured's family will receive insurance proceeds only if the policy is still in force at the time of death (e.g. the insured dies before the age 65 or 70, as the case may be). Ordinary term insurance becomes expensive at that age with the result that most policies are allowed to lapse before death.

   If a comparison of premiums for regular term insurance and level term insurance to age 100 is made over a longer period (say fifteen years), and an appropriate discount factor is applied to premiums payable in the future, the total cost of the two policies will be considerably closer than is indicated by the above figures.

Some farmers will not want to purchase insurance, or will be unable to, and will have to find other methods of realizing their estate planning objectives. One possibility would be to sell their farm property to their farm children at a value that will not only create sufficient retirement capital but will also provide sufficient non-farming assets for the non-farming children. This will often require a sale at an amount that is in excess of the farmer's tax cost and will result in the payment of some income taxes. If the income tax liability is substantial, the

arrangement may not be attractive to the farmer.*

Another approach to this problem is to bequeath the farm to the farm child and to place a mortgage on the property before distributing it to him, thereby creating some non-farming assets that can be transferred to the non-farming children. If the mortgage is payable to the non-farming children (rather than to a financial institution) there will be complete flexibility as to the payment of interest and principal. The repayment terms would not have to be the same as those found in a normal commercial loan but, presumably, they would have to be such that all children were treated equitably. Again, the wording of the will must be reviewed very carefully to ensure there are no tax problems. If Revenue Canada concludes that the farm child has purchased the property from the estate, the rollover will be denied.

The farmer might vary the sale transaction discussed on the previous page by selling only his operating assets to his farming children and leasing his land and buildings to them. After his death, the real property would perhaps pass to his non-farming children and they would be bound by the terms of the lease. If successful, the transaction would provide the farmer with sufficient retirement income and would "equalize" the value of gifts made to all of his children. The problem with this arrangement is that often there are disagreements between the children as to who should be responsible for the improvements to the farm and who should they revert to at the end of the lease period. As well, land and buildings have traditionally experienced greater inflationary gains than most operating assets. Since the farming child will not share in these gains he is sometimes less prepared to maintain the property in the way that he would if it were his own.

Care would have to be taken over the wording of the lease agreement. If it gave the farming children the option to acquire the land and buildings at a percentage of fair market value, and the non-farming children were required to sell the property if the option was exercised, there may be a risk that Revenue Canada would argue that the property does not vest indefeasibly in the non-farming children and the rollover does not apply. This is a matter that the farmer's tax adviser would have to pursue.

In situations where there are several non-farming children and only one or two farm children, it will be considerably more difficult to provide for

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* *It is to be noted that the former Liberal government proposed in its budget of February 15, 1984 that a full-time farmer be able to shelter from tax up to $120,000 of the taxable capital gains arising from the sale of certain farm assets owned on December 31, 1983 by making a special contribution to his RRSP. This proposal is described on page 35 of Chapter 5.*

all children equitably without selling some of the farm assets. Even here, however, it may be possible to preserve the farm with the use of a corporation. The manner in which the corporation might be used is discussed in Chapter 6.

Treating children equally or equitably

There will be many situations in which an equitable distribution among the children will not necessarily be an equal one. The child who decides to stay on the farm may give up certain advantages enjoyed by his brothers and sisters. He may also make a considerable contribution to the farm during his parents' lifetime for which he does not receive adequate compensation. In recognition of this, the farmer may wish to transfer additional property to him.

Whenever this happens it is important that the matter be discussed openly with the family. All of the children must understand the reasoning behind the distribution so that there are no recriminations in later years.

Rental land*

As discussed in Chapter 4, land and buildings that are rented to a corporation are not considered to be used in the business of farming and will generally not be eligible for a tax-deferred rollover when transferred from a farmer to his child. Revenue Canada states in Interpretation Bulletin IT - 268R2 that land and buildings rented to a partnership may also not be treated as farming property if the partners in the partnership include persons other than the farmer, his spouse or any of his children.

If the rental land passes to a spouse trust and then to the children the rollover will be available even though the land is not used in the business of farming by the trust itself. It will be sufficient if the trust rents the property to a farmer, a farm corporation or a farm partnership immediately before the spouse's death.

The farmer should not plan for the rollover to occur on this basis, however. His spouse may not survive him and his property may pass directly to his children. Alternatively, both of them might be killed in a common accident and if the spouse is older than the farmer it will be presumed that she died first and the spouse trust will not come into

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* *The former Liberal government proposed in its February 15, 1984 budget that property leased by an individual to his farm corporation (see Glossary) or to a family farm corporation or partnership (see Glossary) of his spouse or child be treated as property used in the business of farming for purposes of these rollover rules. This change is to be effective for property transferred after December 31, 1983.*

existence.

A preferable method of converting a rental property to one that is eligible for the rollover is to put a custom work contract in place. Unfortunately, there is a great deal of misunderstanding as to what this type of arrangement constitutes. Some people assume that because the document is called a Custom Work Contract "all is well". That is untrue.

The custom work contract is an arrangement that puts the owner of the land into the business of farming. It will not do this if it is simply a crop share rental arrangement.

The method of determining whether or not there is a valid custom work contract is to ask, "how much will have to be paid if there is a complete crop failure?" If the answer is that the owner of the land would have to pay only the property taxes, the arrangement will not be a custom work contract.

Risk is the key factor. Under a custom work contract, the custom operator undertakes the various farming operations from seeding and tillage through to the harvesting operations in exchange for compensation on an hourly or per acre basis, or perhaps a combination of the two. The land owner is responsible for all other expenses except the operating and maintenance costs of machinery. In other words, the land owner pays expenses such as seed, fertilizer, chemicals, sprays, and property taxes, in addition to the custom work fees. The custom work operator is responsible for the fuel, oil, repairs, maintenance, etc. connected with the operation of the machinery. The landowner will determine which fields will be seeded and which will be summer fallowed, what crops will be seeded and which fields will be fertilized and sprayed.

In cases where the lease arrangement is between a farmer and his family farm corporation, the passage into law of the budget proposal referred to in the footnote on page 62 will eliminate the need for a custom work contract in order to preserve a rollover for farm land.

Common problems in wills

The more common types of problems that are found in farmers' wills are as follows:

1. Providing that the farming child has the right to acquire farm property from the estate at a percentage of its fair market value. The farm rollover through a will is available only where the property passes to the child as a consequence of the farmer's death and not where the child purchases the property from the estate.

2. Providing that the property passing on death to a minor child shall be held in trust until he attains the age of majority and, if he fails to attain that age, it shall be distributed to his brothers and sisters. Revenue Canada

takes the position that in this situation the property does not vest indefeasibly in the minor child (because he will not receive it if he fails to attain the age of majority) and the rollover will not apply.

3. Bequeathing shares of a farm corporation to a spouse or child if there is a shareholders' agreement in which there is a provision that requires the spouse or child to sell the shares to other shareholders. Again, Revenue Canada takes the view that the shares will not vest indefeasibly because the spouse or child is required to sell them.

4. In order to provide for the non-farming children, a farmer will sometimes bequeath his operating assets to his farming children and his land and buildings to his non-farming children. Before releasing the property from the estate, the executor is usually instructed to lease the real property to the farming children at a fair rental. Revenue Canada has stated in a private technical interpretation that this will not affect the rollover provided the lease is put in place within fifteen months of the date of death. If the lease gives the farming children the right to acquire the property at a percentage of its fair market value, Revenue Canada may not be prepared to view the property as having vested indefeasibly in the non-farming children. This is a matter that would have to be clarified with Revenue Canada.

5. Bequeathing property to a trust for a spouse where the terms of the trust do not meet all the requirements of a "spouse trust", as set out in the Income Tax Act (see Chapter 4 for requirements).

These and other potential problems are discussed in Revenue Canada's Interpretation Bulletins IT - 449 and IT - 349R.

## CONCLUSIONS

Estate planning is a broad subject that is especially important to the farmer. The capital intensive nature of his business means that there is a need for a well thought-out estate plan. If he neglects this job his family may suffer considerable anguish and there may be financial penalties as well.

The good estate plan is not something that is "hashed out" on an "overnight" basis after an initial consultation with a lawyer or accountant; nor is it something that remains static except in the very latest stages of a person's life. The good estate plan is something that will probably be discussed by the family over a considerable period of time. It will incorporate the considered opinions of all members of the immediate family. The solicitor and accountant will be able to make a useful contribution in the early stages by recommending how the farmer should approach the planning process. They will also be able to advise him of the estate planning tools at his disposal.

The good estate plan will evolve over time. It will be flexible during the period that the children are growing up and deciding what they want to do. It will ensure that the farmer is well provided for during his retirement and that all of his children are treated equitably.

The time devoted to the good estate plan will be repaid many times over in the increased peace of mind of the family and the savings in taxes, estate management costs and property transfer procedures.

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## GLOSSARY OF TERMS USED IN ESTATE PLANNING

**Adjusted cost base:** The "tax cost" that is used to determine the capital gain or capital loss realized on the disposition of a capital property. (See definition of capital property.)

The adjusted cost base (ACB) of land will generally be the amount paid for it although adjustments are required in certain situations. If the land was acquired before 1972, its ACB will generally be determined by reference to its fair market value at the end of 1971.

The ACB of buildings and equipment, etc. will generally be the amount paid for it.

The ACB of an interest in a family farm partnership (see definition of family farm partnership) is determined by reference to the cost of the interest, the capital contributions made to the partnership, the partner's share of profits and losses and his drawings. If the partnership existed at the end of 1971 there are some extremely complicated transitional rules to take into account.

The ACB of shares in a family farm corporation (see definition of family farm corporation) will generally be the amount paid for them although adjustments are required in certain circumstances. If the shares were acquired before 1972, their ACB may be determined by reference to their fair market value at the end of 1971.

**Administrator:** An individual or corporation appointed by a court to administer the estate of a person who dies without making a will or the estate of a person who dies with a will, but without anyone prepared or able to act as executor.

**Agreement for sale:** A sale transaction in which the seller receives the sale price over a period of time and retains title to the sold property until he receives all the payments.

**Allowable capital loss:** The deductible portion (one-half) of the capital loss realized on the sale of a capital property. (See definition of capital property.)

## Glossary of Terms used in Estate Planning

**Attribution rules:** The rules in the Income Tax Act that require income from a property or a capital gain or loss from the disposition of a property to be included in the tax return of a person who does not own the property. These rules apply in certain situations where funds or property are transferred by an individual to his spouse or to his child.

**Bequest:** A gift received from an individual through his will.

**Block averaging:** A method of "income-averaging" that can be used by unincorporated farmers at intervals of not less than five years to reduce their income tax liability.

**Buy-sell agreement:** An agreement between business partners or shareholders which sets out important matters concerning their business relationship, including the manner in which the interests of each of the partners or shareholders are to be purchased on retirement and on death.

**Canada Pension Plan:** A compulsory social security programme of the federal government that provides a retirement pension and certain other benefits.

**Capital beneficiary:** A person who is entitled to a share of the assets held in a trust. (See definition of trust.) The interest of a "capital beneficiary" must be distinguished from that of an "income beneficiary". (See definition of income beneficiary.)

**Capital cost allowance:** The deduction that is allowed for income tax purposes in respect of the reduction in value of buildings, machinery and equipment that occurs through its use. This deduction is often loosely referred to as "depreciation".

**Capital property:** A property that is acquired for investment purposes, or use in a business, that will give rise to a capital gain; and not an income gain, if it is sold at a profit. Land, buildings, machinery, equipment, shares in a farm corporation and an interest in a farm partnership will usually be capital property to the farmer.

**Clearance certificate:** A certificate to be obtained from Revenue Canada by the personal representative of a deceased taxpayer before distributing the assets of the estate. Failure to obtain the certificate can

**Clearance certificate (continued):** make the personal representative personally liable for the deceased's outstanding tax liability.

**Codicil:** An addendum to a will.

**Cost amount:** A term meaning the "tax value" of a particular property.

The "cost amount" of typical farming properties is as follows:

| | |
|---|---|
| Land | - its adjusted cost base (see definition of adjusted cost base); |
| Buildings, equipment etc., depreciated on the reducing balance basis | - its undepreciated capital cost (UCC) for tax purposes (see definition of UCC); |
| Buildings, equipment etc., depreciated on the straight line basis | - its original cost, or its value at the end of 1971, if higher; |
| Intangible assets such as quota | - the amount of the cumulative eligible capital (see definition); |
| Interest in a family farm partnership | - its adjusted cost base (see definition of adjusted cost base); |
| Shares in a family farm corporation | - their adjusted cost base (see definition of adjusted cost base). |

**Cumulative eligible capital:** The amount of a taxpayer's undepreciated expenditures on intangible assets such as quota. (These intangible assets are called eligible capital properties - see later definition.)

**Distribution tax:** The 12 1/2% tax payable by private companies on dividends paid out of income that has been taxed at the low corporate rate of 23%.

**Earned income:** The income that may be contributed (within limits) to a registered retirement savings plan.

**Eligible capital property:** Intangible properties (such as quota or goodwill) acquired in connection with a business. One-half of the expenditure on such properties is added to the taxpayer's cumulative eligible capital and depreciated for tax purposes.

**Family assets:** The assets which, under B.C. Family Law, must be divided between a husband and wife in the event of a marriage breakdown unless the court otherwise orders.

**Family farm corporation:** A farming corporation that meets certain tests in the Income Tax Act so that its shares may be transferred from one generation to the next on a "rollover basis". (See definition of "rollover"). The corporation must use all or substantially all of its assets in carrying on a farming business in Canada and the farmer, his spouse or one of his children must be actively involved in that business. A holding company will qualify as a family farm corporation in certain situations.

**Family farm partnership:** A farming partnership that meets certain tests in the Income Tax Act so that the partners' interests may be transferred from one generation to the next on a "rollover basis". (See definition of "rollover".) The partnership must use all or substantially all of its assets in carrying on a farming business in Canada and the farmer, his spouse or one of his children must be actively involved in that business.

**Family Relations Act:** The legislation in British Columbia that deals with the division of assets that occurs when there is a marriage breakdown.

**Formal will:** A document, usually type-written, setting out an individual's wishes regarding the disposition of his assets after his death, signed by the individual and two witnesses in the presence of each other.

**Forward averaging:** A method of reducing tax in years of high income by averaging the excess income over future years.

**Guaranteed renewal clause:** A clause in a term insurance policy requiring the insurer to renew the policy even when the insured's health deteriorates. (See definition of term insurance.)

**Income beneficiary:** A person who is entitled to share in the income

## Glossary of Terms used in Estate Planning

| | |
|---|---|
| Income beneficiary (continued): | earned on assets held in trust. (See definitions of trust and capital beneficiary.) |
| Income-splitting: | An arrangement which has the effect of transferring income from a "high tax-rate" person to a "low tax-rate" person so that the overall tax liability is reduced. |
| "In specie": | A personal representative can distribute assets from an estate "in specie" (e.g. in their present form) or, if authorized by the will, can sell them and distribute the cash proceeds. |
| Inter-Vivos: | An "inter-vivos" transaction of a particular person is one carried out during his lifetime, rather than after his death. |
| Intestate: | The term used to describe the estate of a person who dies without leaving a will. |
| Issue: | All persons descended from a common ancestor. |
| Joint tenancy: | A form of co-ownership under which the interest of a deceased person automatically passes to the co-owners. |
| Letters of Administration: | A court-approved document giving a person the right to administer the estate of a person who dies without leaving a will. |
| Life annuity: | An annuity that is payable throughout the life of the annuitant. There may be a guaranteed minimum pay-out period or a "joint and last survivor option" under which payments continue until the death of the survivor of the taxpayer and his spouse. |
| Life estate: | An interest in property limited in time to the life of a particular person. |
| Old Age Security: | The "old age" pension payable by the federal government to persons who meet the age and residence tests. |
| Permanent insurance: | A type of life insurance that continues its coverage through to the death of the person insured. (See definition of term insurance.) |
| Per stirpes: | The basis of dividing the share of a deceased beneficiary amongst his descendants according to their relationship to the deceased. (e.g. A father dies and is survived by his son and two |

**Per stirpes (continued):** children of his deceased daughter. On a per capita basis each would receive one-third whereas on a per stirpes basis the son would receive one-half and each grandchild would receive one-quarter.)

**Preferred Beneficiary Election:** An income tax election filed by the trustee and beneficiary of a trust which "deems" certain income that is received and retained by the trust to be the income of the beneficiary.

**Principal residence:** An owner-occupied home that can be sold at a profit without resulting in tax.

**Qualifying farm property:** A term used in this book to describe the farming assets that can be transferred by an individual to his child on a rollover basis. The property is:

- land;
- buildings, equipment, etc. depreciated for income tax purposes on the reducing balance basis;
- eligible capital property (e.g. quota) (see definition);
- shares in a family farm corporation (see definition); and
- an interest in a family farm partnership (see definition).

The land, buildings and equipment, etc. must be owned by the individual and must be used by him, his spouse, or any of his children in the business of farming in Canada, immediately before the transfer. Quota must also meet this test if it is transferred to the child during the individual's lifetime.

**Registered Home Ownership Savings Plan:** A plan offered by a financial institution, and registered with Revenue Canada that allows an individual to deduct up to $1,000 from his income each year (lifetime maximum of $10,000) in respect of contributions to the plan. The funds compound free of tax while retained in the plan and can be withdrawn free of tax if they are used to purchase an owner-occupied home.

| | |
|---|---|
| Registered Retirement Income Fund: | A fund administered by a financial institution and registered with Revenue Canada, into which an individual can transfer his accumulated registered retirement savings plan monies on retirement. The individual would then receive amounts from the fund, computed on a formula basis, throughout the remainder of his life. |
| Registered Retirement Savings Plan: | A plan offered by a financial institution and registered with Revenue Canada, that allows an individual to save for his retirement by contributing amounts to the plan each year. The amount contributed is deductible from the individual's income and compounds free of tax while it is held in the plan. |
| Reserve: | A deduction that may be claimed for income tax purposes in a particular year, where a taxpayer sells a property and the sale price is payable over a period that extends beyond the end of that year. |
| Rights or things: | The term given to items such as livestock, inventories and accounts receivable of a "cash-basis farmer" that are given special treatment in the final income tax of a deceased individual. |
| Rollover: | The term that is used to describe a "tax-deferred" transfer of property in which the person acquiring the property inherits the transferor's tax cost. |
| Siblings: | Brothers or sisters. |
| Small Business Bond: | A special type of low-interest loan made to a business that is in financial difficulty for which a special election has been filed with Revenue Canada. The interest on the bond is not deductible by the business nor taxable to the lender. |
| Sole proprietorship: | A business carried on by an individual. |
| Spouse trust: | A trust established by a taxpayer for the benefit of his spouse. Property transferred to such a trust is deemed to be disposed of for income tax purposes on a "rollover basis" if certain requirements are met. |
| Taxable capital gains: | The taxable half of the profit realized on the disposition of a capital property. (See definition of capital property.) |

| | |
|---|---|
| Tenancy in common: | A form of co-ownership, under which the co-owner's interest can be gifted, sold or bequeathed to any person. |
| Term annuity: | An annuity payable for a specified number of years. |
| Terminal loss: | The undepreciated capital cost (UCC) of a particular fixed asset class that can be deducted from income when all assets of that class have been disposed of. (See definition of UCC.) |
| Term insurance: | A type of life insurance that is usually less expensive than other types and is renegotiated on the policy anniversary date. It becomes progressively more expensive as the individual becomes older and may become non-renewable if the individual's health deteriorates and he does not have a guaranteed renewal clause in his policy. (See definitions of guaranteed renewal clause and permanent insurance.) |
| Testamentary trust: | A trust established by the will of a deceased individual. (See definition of trust.) |
| Testator: | The person who makes a will (testator - male; testatrix - female). |
| Trust: | An arrangement under which assets are set aside by an individual and administered by a trustee for the benefit of another person. |
| Undepreciated capital cost (UCC): | The undepreciated expenditures in respect of buildings, machinery and similar properties, calculated by asset class, and written off on a reducing balance basis. |
| Vest indefeasibly: | A property "vests indefeasibly" if the person acquiring it obtains a right to absolute ownership in such a manner that the right cannot be taken away by any future event. |
| Wills Variation Act: | A statute in British Columbia that allows a court to vary the provisions of a will if it considers that the testator has not provided adequately for his spouse or children. |

## TABLE OF INTESTATE SUCCESSION IN BRITISH COLUMBIA

| If a Person Dies Intestate Leaving: | The Estate Will be Distributed as follows: |
|---|---|
| 1. Spouse and no Issue | Whole Estate to Spouse |
| 2. Spouse and one Child or Issue | First $65,000.00,<br>All Household Furnishings,<br>Matrimonial Home (life estate only) and<br>1/2 Residue to Spouse and<br>1/2 Residue to Child or Issue |
| 3. Spouse and more than one Child or Issue | First $65,000.00,<br>All Household Furnishings,<br>Matrimonial Home (life estate only) and<br>1/3 Residue to Spouse and<br>2/3 Residue equally to Children and Issue |
| 4. One or more Children or Issue but no Spouse | Whole Estate to Intestate's Children equally,<br>Per Stirpes to Issue of a Deceased Child |
| 5. Father and Mother but no Spouse or Issue | Whole Estate to Parents equally |
| 6. Father but no Mother, Spouse or Issue | Whole Estate to Father |
| 7. Mother but no Father, Spouse or Issue | Whole Estate to Mother |
| 8. Siblings but no Spouse, Issue or Parent | Whole Estate to Siblings equally |
| 9. Siblings and Children of Deceased Siblings but no Spouse, Issue or Parent | Whole Estate to Siblings equally, Per Stirpes to Children of Deceased Sibling |
| 10. Children of Deceased Siblings but no Spouse, Issue, Parent or Sibling | Whole Estate equally to Nieces and Nephews alive at Intestate's death |
| 11. No Spouse, Issue, Parent, Sibling or Child of Deceased Sibling | Whole Estate to next of kin of equal degree of blood relationship to Intestate alive at Intestate's death equally |

Refer to the Glossary for the meaning of the terms "issue", "siblings", "life estate" and "per stirpes".

Prepared from information supplied by W.M.R. Newby of Baker, Newby & Company, Barristers & Solicitors

## ILLUSTRATION OF THE TAX DEFERRAL THAT CAN BE OBTAINED BY THE USE OF A CORPORATION

Assume that farm profits before payment to the farmer are $80,000 and that the farmer needs $40,000 to live on.

CORPORATION (assumes business carried on by corporation)

| | | | |
|---|---|---|---|
| Farm profits | | | $ 80,000 |
| Before-tax income required by farmer (paid from corporation as a salary) | | | 40,000 |
| "Excess" income retained in corporation | | | 40,000 |
| Corporate tax - 23% | | | 9,200 |
| Income retained and available for dividend | | (A) | $ 30,800 |
| Income retained and available for dividend | | | $ 30,800 |
| Distribution tax | | | 3,422 |
| Net dividend to farmer | | | 27,378 |
| Tax on dividend - farmer (Notes 1 and 2) | | | 5,753 |
| Net to farmer from dividend | | (B) | 21,625 |
| Net to farmer from $40,000 salary (Note 1) | | (C) | 27,135 |
| Net to farmer in total | | (D) | $ 48,760 |

INDIVIDUAL (assumes business carried on by individual)

| | | | |
|---|---|---|---|
| Income | | | $ 80,000 |
| Less tax (Note 1) | | | 31,894 |
| Net to farmer | | (E) | $ 48,106 |

TAX DEFERRAL

Income retained:

| | | | |
|---|---|---|---|
| If corporation used: | | | |
| - retained by farmer from salary | (C) | 27,135 | |
| - retained by company | (A) | 30,800 | $ 57,935 |
| If corporation not used: | | | |
| - retained by farmer | | (E) | 48,106 |
| Tax deferral | | | $ 9,829 |

## Illustration of the Tax Deferral that can be Obtained by the use of a Corporation

TAX SAVINGS

Net to farmer:

| | | |
|---|---|---|
| If corporation used: | (D) | $ 48,760 |
| If corporation not used: | (E) | 48,106 |
| Tax saving (Note 3) | | $ 654 |

NOTES:

1. It is assumed that the farmer's exemptions are offset by his non-farming income, the federal marginal rates are those applying in 1984 and the provincial tax rate is 44%. The federal tax reduction and the provincial health care maintenance surtax have been ignored.

2. This is the tax that the farmer would pay on the dividend - assuming he had already received a $40,000 salary.

3. Theoretically, the distribution tax is supposed to remove all of this tax saving. A small saving remains, however, for a corporation in British Columbia, because of imperfections in the tax system.

It is important to remember that there will be a tax deferral only if the corporation generates more income than the farmer needs to live on and the excess is retained by the corporation. If all the income is flowed through to the farmer, he will be in approximately the same position as he would have been had he not used the corporation.

A farmer can perhaps increase the tax benefits arising from the use of a corporation by arranging for some of the shares to be held by his spouse or children. Income that would otherwise be taxed in his return as farm profits would then be taxed in his spouse's or children's returns as dividend income. The effect of this arrangement is that income is split between the farmer and other family members and the overall income tax liability is reduced.

## ILLUSTRATION OF THE POSSIBLE USE OF A CORPORATION IN DEALING WITH NON-FARM CHILDREN

### Situation

Assume that a farmer who is about to retire has one son and 3 daughters and that his only significant asset is his farm which he would like to pass to his son. Assume that he is prepared to freeze his interest in the farm and to allow future increases in value to accrue to his son. Assume also that the farm has no debt.

The particulars of the farm are as follows:

| | "Tax Basis" | Fair Market Value |
|---|---|---|
| Land - adjusted cost base | $ 150,000 | |
| - fair market value | | $ 500,000 |
| Buildings, equipment | | |
| - undepreciated capital cost | 125,000 | |
| - fair market value | | 300,000 |
| Livestock, inventories | | |
| - tax value | NIL | |
| - fair market value | | 155,000 |
| Quota | | |
| - 2 x cumulative eligible capital | 100,000 | |
| - fair market value | | 400,000 |
| | $ 375,000 | $ 1,355,000 |
| Accrued untaxed gain | $ 980,000 | |

### Plan

1. The farmer would establish a corporation with three different classes of shares.

   Voting common shares

   These would be the growth shares that would entitle the holder to one vote per share. Initially, they would have a nominal value but would increase in value as the farm grows. 100 of these shares would initially be issued to the farmer for $1 each and after a short holding period (say one or two months), would be gifted to his son. Structuring the transaction in this manner avoids potential sales tax problems.

Voting preferred shares (Class A preferred)

These would be fixed-value shares through which the farmer would continue to exercise some "parental control" over the farm. Each share would entitle the farmer to one vote. He would acquire 300 of these shares at $1 each thus entitling him to 300 votes. Holding this number of votes would, if necessary, enable him to pass a special resolution authorizing the sale of the farm.

Non-voting preferred shares (Class B preferred)

These would be fixed-value, non-voting preferred shares that the farmer would receive in exchange for the farming assets to be transferred to the company. They would be redeemable on demand and would entitle him to a reasonable "non-cumulative" dividend. The "non-cumulative" feature means that if a dividend is not declared in a year, the right to receive that dividend is lost and is not carried forward to future years.

2. The farmer, his wife and his son would be appointed directors of the company.

3. The farming assets would be transferred to the company on a rollover basis using the rules in section 85 of the Income Tax Act. The sale would be made at fair market value and the consideration given by the company would be as follows:

| | |
|---|---|
| Issue of debt for an amount equal to the farmer's "tax basis". This debt would be payable on demand and may entitle the farmer to a reasonable interest rate. (If the farmer had debts of, say, $200,000, they could be assumed by the company and the debt payable to the farmer would be reduced to $175,000.) | $ 375,000 |
| Issue of non-voting Class B preferred shares with a value equal to the accrued gain on the farm | 980,000 |
| | $ 1,355,000 |

An income tax election would be filed with Revenue Canada.

4. As mentioned above, the Class B preferred shares would be redeemable on demand during the lifetime of the farmer (perhaps during the lifetime of his spouse as well - if she survives him and inherits the shares). After their death, the shares would be redeemable serially over a period of years. The period selected would depend on the

ability of the farm to generate the cash required to finance the redemption.

5. The debt and Class B preferred shares would represent the farmer's retirement capital. Debt repayments and interest on the debt would probably form the bulk of the farmer's retirement income. Additional income in the form of dividends on the Class B preferred shares would be received as required. The debt repayments would not be subject to tax as they would represent a return of the cost of the farmer's investment in the farming assets transferred to the corporation.

6. On the farmer's death, some or all of the Class B preferred shares and debt would pass to his spouse. She might acquire the Class A voting preferred shares as well.

   On her death, the Class A voting preferred shares would pass to the son and the Class B preferred shares would pass to all the children. The shares would transfer on a rollover basis provided the corporation qualified as family farm corporation.

7. Over the period following the death of the farmer and his wife, the Class B preferred shares held by the three daughters would be redeemed. Income tax would be payable on the redemption proceeds. Assuming the plan is well thought-out, the farm would generate sufficient income in this period to finance the redemption.

8. The effect of the above would be as follows:

   - the farmer would be able to exercise some "parental control" during his lifetime and his retirement needs would be met;

   - the farmer's son would inherit the farm intact and would be able to run it without interference;

   - the farmer's daughters would acquire an equitable interest in the farm and, ultimately, this inheritance will be received in cash;

   - income tax on the accrued gain on the farm at the date of its incorporation would be deferred until the daughters began to redeem their shares;

   - the share interests of the daughters would be redeemed using funds in the company that would not have been subject to tax at the shareholder level. This would minimize the funds that would have to be generated by the farm in order to finance the redemption. This can be illustrated as follows:

| | | |
|---|---|---|
| I | Value of Class B preferred shares passing to daughters (3/4 x $980,000) | $ 735,000 |

## Illustration of the Possible Use of a Corporation in Dealing with Non-farm Children

| | | |
|---|---|---|
| Tax rate in company (see note) | | 23% |
| Before - tax profits required from farm to finance the redemption | (A) | $ 954,545 |
| II Before-tax profits that would have been required from the farm if it is assumed that: | | |
| (a) a corporation had not been used; | | |
| (b) the farmer had provided in his will that after his death a mortgage be placed on the farm in the amount of $735,000 and that the proceeds be paid to the daughters; and | | |
| (c) the average tax rate of the farmer's son was 35% | | |
| Before-tax profits required (ignoring amount needed to cover interest) $\frac{735,000}{65} \times 100$ | (B) | $ 1,130,769 |
| III Additional funds required (B) - (A) | | $ 176,224 |

Note: It is assumed that the 12 1/2% distribution tax would not apply to this redemption. If it did, the effective tax rate in the company would be increased to approximately 31.5% and the before-tax profits required from the farm would increase accordingly.

The above is only an outline of a plan that might be satisfactory in certain situations. In a real-life situation, there would be many details that would have to be tailored to the farmer's particular circumstances. It is absolutely vital that this be done with the benefit of expert professional advice because there are many potential income tax problems. Depending on the circumstances, the adviser may wish to obtain an advance income tax ruling from Revenue Canada.

## ILLUSTRATION OF THE INCOME TAX RULES FOR THE CALCULATION OF RESERVES, WHERE PROPERTY IS SOLD AND PART OF THE SALES PROCEEDS REMAINS UNPAID

**Assume**

A farmer sells land to his son in January, 1983 for $480,000 and the total of his "adjusted cost base" (ACB) and the costs of disposition are $100,000.

The son makes a down payment of $120,000.

The balance owing of $360,000 ($480,000 - $120,000) is secured by a mortgage and is not repayable until the end of twelve years.

**Calculations**

Capital Gain

| | | | |
|---|---|---|---|
| Sale proceeds | | | $ 480,000 |
| ACB plus costs of disposition | | | 100,000 |
| Capital gain before reserve | | | 380,000 |
| Reserve equals the lesser of: | | | |
| (a) $\frac{\text{Debt ($360,000)}}{\text{Sale price ($480,000)}}$ x gain ($380,000) = | | $ 285,000 | |
| And | | | |
| (b) $\frac{9}{10}$ x gain ($380,000) = | | $ 342,000 | |
| Lesser amount | | | 285,000 |
| Capital gain, after reserve | | | $ 95,000 |
| Taxable capital gain (one-half), included in 1983 tax return | | | $ 47,500 |

In each of the nine years following the year of sale, the farmer would treat as a capital gain the reserve claimed at the end of the preceding year and would then claim a new reserve. The new reserve for any particular year would be based on the amount of debt not due at the end of that year but could not exceed 1/10th of the original capital gain ($380,000) times the number by which 9 exceeds the number of preceding

taxation years ending after the disposition of the property. The effect of this rather complicated rule is that the reserve which is available to the farmer is gradually reduced to nil over the nine years following the year in which the sale is made. At the end of this period, the farmer will have paid all his tax liability even though he may not have received all of the proceeds from the sale of his farm.

In this illustration, the maximum reserve that could be claimed by the farmer at the end of each year and the taxable capital gain that would be included in his income each year is as follows:

| Year After Sale | Closing Reserve | Capital Gain | Taxable Capital Gain |
|---|---|---|---|
| 1 | $ 285,000 | $ NIL | $ NIL |
| 2 | 266,000 | 19,000 | 9,500 |
| 3 | 228,000 | 38,000 | 19,000 |
| 4 | 190,000 | 38,000 | 19,000 |
| 5 | 152,000 | 38,000 | 19,000 |
| 6 | 114,000 | 38,000 | 19,000 |
| 7 | 76,000 | 38,000 | 19,000 |
| 8 | 38,000 | 38,000 | 19,000 |
| 9 | NIL | 38,000 | 19,000 |
| | | 285,000 | 142,500 |
| Amount calculated for year of sale (see above) | | 95,000 | 47,500 |
| Total | | $ 380,000 | $ 190,000 |

## ESTATE PLAN INFORMATION

### ADVISERS AND OTHER PERSONS

| | Name | Tel.# and address |
|---|---|---|
| Accountant | | |
| | | |
| Bank | | |
| | | |
| Executors | | |
| | | |
| Insurance agent | | |
| | | |
| Solicitor | | |
| | | |
| Witnesses to will | | |
| | | |
| Others | | |
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### BUSINESS INFORMATION

| Item | # | Location |
|---|---|---|
| Chequing accounts | | |
| | | |
| Safety deposit box | | |
| | | |
| Savings accounts | | |
| | | |

(Update periodically)

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## ESTATE PLAN INFORMATION

### ASSETS

| REAL ESTATE | | |
|---|---|---|
| Property address | % Owned | Location of Deeds |
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| MORTGAGES AND AGREEMENTS RECEIVABLE | | | |
|---|---|---|---|
| Principal Amount | Property Address | Mortgagor/ Purchaser | Location of Documents |
| | | | |
| | | | |
| | | | |
| | | | |

| TERM DEPOSITS, SHARES, BONDS AND OTHER INVESTMENTS | | |
|---|---|---|
| Principal Amount or # of Shares | Description of Investment | Location of Security |
| | | |
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## ESTATE PLAN INFORMATION

**ASSETS (continued)**

| FARM MACHINERY, EQUIPMENT AND VEHICLES | | |
|---|---|---|
| Item | Year, Make and Model | Location |
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## ESTATE PLAN INFORMATION

**ASSETS (continued)**

| FARM MACHINERY, EQUIPMENT AND VEHICLES | | |
|---|---|---|
| Item | Year, Make and Model | Location |
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| LIVESTOCK | |
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| Number | Description |
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**(Update periodically)**

**Cut out and retain with records**

## ESTATE PLAN INFORMATION

### INSURANCE

| INSURANCE POLICIES | | | |
|---|---|---|---|
| Principal Amount | Insurance Company | Policy # | Location of Policy |
| | | | |
| | | | |
| | | | |
| | | | |

### LIABILITIES

| MORTGAGES AND AGREEMENTS PAYABLE | | |
|---|---|---|
| Principal Amount | Property Address | Location of Documents |
| | | |
| | | |
| | | |
| | | |

| BANK LOANS | |
|---|---|
| Principal Amount | Name and Address of Bank |
| | |
| | |
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| INSURANCE POLICY LOANS | | | |
|---|---|---|---|
| Principal Amount | Insurance Company | Policy # | Use of Funds |
| | | | |
| | | | |

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## ESTATE PLAN INFORMATION

### LEASED PROPERTY

| Name and Address of Landlord | Address of Leased Property | Renewal Date |
|---|---|---|
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### CREDIT CARDS

| Company | Card # |
|---|---|
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### SUPPLIERS WITH CHARGE ACCOUNTS

| Name | Address |
|---|---|
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(Update periodically)

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## ESTATE PLAN INFORMATION

### LOCATION OF WILL

| Address | Person to Contact |
|---|---|
| | |
| | |
| | |

### DATE INFORMATION LAST UPDATED

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